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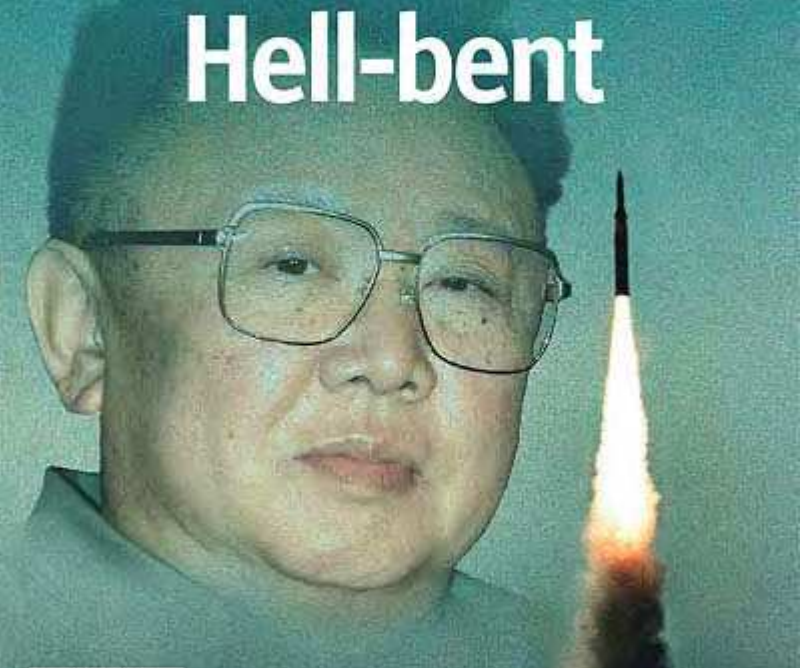

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Politics this week

May 1st 2003
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Middle East road map

Reuters

The **road map**, an international blueprint for ending the conflict between Israelis and Palestinians by 2005, was submitted to both their governments after a new Palestinian cabinet was sworn in. The map, which offers a three-stage route, has been accepted as it is by the Palestinian leaders. The Israelis have crucial reservations, particularly on the call for a settlement freeze.

See article: On the road to peace

As evidence of the continuing violence, a **suicide bomber**, apparently a British citizen, blew up himself and three others at a seafront café in Tel Aviv. Israel retaliated in Gaza, killing eight people.

Donald Rumsfeld, America's secretary of defence, visited Baghdad. He told the Iraqis that American troops would stay only as long as it took to ensure a democratic government. Talks between some of Iraq's innumerable political groups and factions continued, in some disorder.

See article: The next phase of the campaign

American troops **opened fire** on protesters in Falouja, a town near Baghdad, killing 13 people. When residents protested against these deaths, the Americans fired again, killing at least two more. American soldiers were then injured in a grenade attack.

The United States said that virtually all its troops, except for a few training people, would be pulled out of **Saudi Arabia**. America's military presence in the country has been a prime reason for Osama bin Laden and his followers to justify violence against America.

See article: America and the Gulf

Russia's president, Vladimir Putin, annoyed the American-British coalition by saying that UN sanctions against Iraq should stay in place until the UN decides that the country no longer has weapons of mass destruction.

At a summit, France, Germany, Belgium and Luxembourg agreed on the outlines of a scheme for a multinational headquarters for non-NATO **European defence** operations**.** Not anti-NATO, they said. Better not be, said Britain, Spain and NATO. The United States was not amused.

See article: A small group of Europeans tries to undermine NATO

Locked up

In a controversial decision, the American Supreme Court ruled that the government can detain legal **immigrants** without bail during their deportation proceedings. The five-to-four ruling applies to non-citizens who have served sentences for serious crimes.

Congress could end up passing a **tax cut** of as much as $450 billion, less than President George Bush

wanted but more than that agreed by the Senate, said Charles Grassley, chairman of the Senate Finance Committee. Alan Greenspan, the Fed chairman, repeated his worries about tax cuts with no matching spending cuts.

Unbeaten SARS

AP

The pneumonia-like disease SARS tightened its grip on **China**. Beijing reported more than 100 new infections a day, with 1,440 confirmed cases and 75 deaths. Schools and theatres were closed and about 10,000 people were in quarantine. At least 372 people have died of the disease worldwide. The good news was that the World Health Organisation ended its warning against travel to Toronto and Vietnam.

See article: China and SARS

The United States said it was considering a conditional offer by **North Korea** to disband its nuclear-weapons programme, but it was not prepared to “reward” the North with aid for “bad behaviour”.

See article: Dealing with North Korea

Pakistan said it had arrested six members of a group linked to al-Qaeda. One of the six was said to have been involved in an attack on an American warship, the *USS Cole*, in 2000.

Dozens of countries around the equator, among them **Malaysia** and **Indonesia**, were warned that they could be hit by debris from an Italian satellite falling to Earth after seven years in space. It landed harmlessly in the Pacific.

Peronist pair

Two Peronists face a run-off election on May 18th for **Argentina's** presidency. In the first round, Carlos Menem, a conservative former president, won 24%, just ahead of Néstor Kirchner, a provincial governor from Patagonia (22%). Mr Kirchner looked better placed to attract non-Peronist voters in the run-off.

See article: Argentina's presidential election

The Colorado Party, which has (mis)governed **Paraguay** for 56 years, will run it for another five. Nicanor Duarte Frutos, a former education minister, won the presidential election with 38% of the vote.

See article: Paraguay's presidential election

Brazil's president, Luiz Inácio Lula da Silva, presented to Congress long-awaited draft bills to reform pensions and the tax system. He delivered the bills personally, accompanied by a delegation of state governors.

Two Sikh nationalists went on trial in Vancouver, accused of involvement in the 1985 bombing of an Air India flight which killed 329 people, the bloodiest act of aerial terrorism before September 11th 2001. The trial is expected to be one of the biggest in **Canada's** history, involving some 150 witnesses and lasting well into autumn.

See article: Canada's terrorism trial

Reforming

Germany's chancellor, Gerhard Schröder, threatened to resign if his Social Democrats would not back his plans to reform unemployment rules and other aspects of his country's generous welfare state. Party officials at a big regional pow-wow in Bonn duly voted in favour of the scheme.

An **Italian** court delivered a guilty verdict and a sentence of 11 years imprisonment against a former defence minister, Cesare Previti, a close friend of the prime minister, Silvio Berlusconi, for bribing judges in earlier cases.

See article: Italian trials

The **French** government announced plans both to boost the birth rate and to encourage women with children to rejoin the labour force. Cost: $1.3 billion a year.

See article: The French family

An **earthquake** measuring 6.4 on the Richter scale hit south-eastern Turkey demolishing buildings including a boarding school dormitory. Up to 150 were feared dead.

AP

Troubled Nigeria

Nearly 100 expatriate oil-workers were held hostage by their local colleagues on oil rigs off the coast of **Nigeria**. On April 30th the Nigerian navy was dispatched to free them.

See article: Kidnapping oil workers

Burundi swore in a new president, Domitien Ndayizeye, a Hutu. He was given the job as a goodwill gesture by the country's Tutsi elite, who dominate the army, to the Hutu majority, who say they feel oppressed.

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Business this week

May 1st 2003
From The Economist print edition

Wall Street's settlement

American securities regulators reached a $1.4 billion settlement with ten Wall Street investment banks, ending months of government wrangling over past practices. Three banks, **Citigroup Salomon Smith Barney**, **Merrill Lynch** and **Credit Suisse First Boston**, were singled out for “fraud”. The agreement forces all the banks to keep separate the work of equity analysts and investment bankers.

See article: Day of reckoning

As part of the agreement, **Henry Blodget**, a former Merrill Lynch internet analyst, was fined $4 million; and **Jack Grubman**, a former Salomon Smith Barney telecoms guru $15 million. Both were barred from the securities industry for life. In an e-mail found by regulators, Mr Blodget once referred to a company whose shares his firm was flogging as a “piece of junk”.

In a separate investigation, the SEC levied fines of $2.7m against **Ron Baron**, manager of Baron Capital, a New York hedge fund, and two of his colleagues. Regulators allege that he manipulated share prices in order to influence the terms of a merger.

Tyco International's woes continued. The Bermuda-based company said that it found $1.1 billion of additional accounting errors, after receiving an apparently clean bill of accounting health last year.

Hans-Jürgen Schinzler resigned as head of **Munich Re**, the world's biggest reinsurer, after the company's share price lost more than three-quarters of its value over the past three years. Nikolaus von Bomhard takes over.

See article: A new boss at Munich Re

The **Basel Committee** set out new rules for banks' balance sheets. Due to take effect in 2006, the rules will reduce the amount of capital banks set aside for mortgages. That led to fears of overheating in loans for residential property.

Paying with plastic

Visa agreed to pay retailers $2 billion to settle a suit over charges. Earlier, **MasterCard** had reached a $1 billion settlement. The shopkeepers argued that both MasterCard and Visa charged excessive fees to merchants for using their proprietary networks.

See article: Visa and MasterCard settle with retailers

The effects of the euro are finally being felt at the **Bank of France**, which said it would cut 2,500 jobs as part of a broad restructuring. With its 211 branch offices, the French central bank is the last in Europe to provide personal accounts and deposit boxes.

Play it again

America's **record industry** sent an electronic message to users of internet music-sharing services to warn them of possible legal action to stop music piracy.

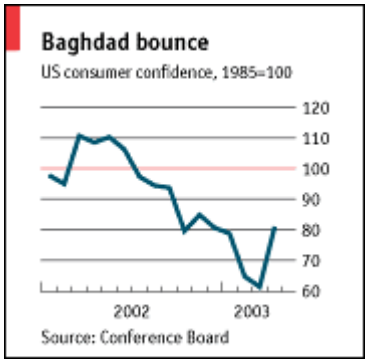
See article: What to do about online music

Vivendi Universal will sell its entertainment assets, including Universal Pictures, its Hollywood studio, and its theme-parks and video-games businesses. It plans to focus on telecommunications.

Shares in **Cordiant Communications**, a British advertising and marketing company, fell by 65% in one day, after it lost one of its biggest clients, Allied Domecq, a drinks company. Cordiant is now considering an asset sale.

McDonald's profits rose by 29% in the first quarter, although global sales of its fast food remain depressed. Even so, Jim Cantalupo, boss of the fast-food company, promised shareholders a big dividend increase this year.

American consumer confidence rebounded sharply in April, as a quick end to the war in Iraq helped to lift spirits. The Conference Board's index rose by 20 points to 80.



Leaving home

Infineon, a German microchip maker, said it was considering moving its headquarters to Switzerland from Germany, in a bid to avoid its home country's high corporate taxes.

SARS is battering **China's economic prospects**. Goldman Sachs, like many banks, revised its economic forecast: it says China's economy will grow at only 6.0% this year if the epidemic lasts for more than six months, down from an earlier forecast of 7.5%.

See article: Painful side-effects

Corus, an Anglo-Dutch steel maker, announced 1,150 job cuts at its British mills and said it was in talks to rescue ailing parts of its business.

GlaxoSmithKline cut the price of its AIDS drug treatment. Investor and campaigning groups have lobbied the company about the ability of AIDS patients in poor countries to pay for drugs.

Bless America

Singapore Technologies Telemedia will try to buy Global Crossing, a bankrupt telecoms company, on its own after America discouraged its Hong Kong partner in the deal, **Hutchison Whampoa**.

Bechtel, which won an American contract to rebuild Iraq's infrastructure, said it would share the work with foreign subcontractors.

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North Korea

Hell-bent

May 1st 2003
From The Economist print edition

Dealing with the danger from a nuclear North Korea

Get article background

IT IS hard to exaggerate the danger in North Korea's finger-on-trigger taunts to America and the world that it already has a few nuclear bombs, is busily producing the stuff to build more, and will make use of them in whatever ways it chooses. Such nuclear swagger from one of the world's reckless squad jeopardises peace on the Korean peninsula. It also endangers stability in East Asia, where threats hurled at the neighbours risk setting off an arms race and a chain reaction that could tempt several countries, including Japan, South Korea and Taiwan, to turn nuclear at speed. And it aims another damaging strike (after Iraq's teasing of weapons inspectors and recent revelations about Iran's uranium enrichment) at the Nuclear Non-Proliferation Treaty (NPT), whose members opened a treaty review this week in an anxious huddle.

Yet it is no big surprise that North Korea should have in effect declared itself the world's ninth nuclear power. America's CIA has long guessed that before an earlier crisis-defusing deal back in 1994, under which the regime agreed to freeze and eventually dismantle plutonium production in return for generous energy assistance, North Korea had probably already got its hands on enough material for perhaps one or two bombs. That crisis had its spine-prickling moments, but this one could be far more dangerous. For, if Kim Jong Il's nuclear claims are true, he may soon have five or six more, with options on others. And more weapons mean enough spares to be able, say, to test one to intimidate the neighbours; or to auction one off to the highest bidder (an Iran, a Libya, or perhaps even an Osama bin Laden). How this crisis unfolds therefore depends on what Mr Kim really does intend to do with his bombs.

Surprise, surprise

North Korea says it presented America with a “new bold proposal” for eventually scrapping them at tripartite talks last week that also involved China. When this latest crisis started in October, after America had surprised North Korea with the evidence that it was secretly and illegally enriching uranium, and North Korea surprised everyone by owning up to it, President George Bush was preparing to offer his own “bold initiative”. The idea, he says, would be to transform America's relations with the place if it put a comprehensive end to the security threat it poses—with its nuclear weapons, its far-flying missiles and its guns pointed at South Korea.

Might these two boldnesses yet be turned into the peaceful diplomatic solution that all sides say they want? North Korea certainly has need of the aid, trade and investment that South Korea, Japan, America and others have all at various times held out to it as an inducement to scrap its nuclear ambitions. But Mr Kim has now thrown up new obstacles, and any new deal will be that much harder to win.

The biggest difficulty is Mr Kim's serial promise-breaking. His first shot at plutonium-making back in the early 1990s had already broken both the NPT and a North-South agreement to keep the peninsula nuclear-free. His recently discovered uranium enriching, and his claimed resumption of plutonium reprocessing, have in effect consigned these agreements and his 1994 one with America to the shredder. How could anyone be sure he would honour a new one?

Don't trust, verify

Only by including intrusive checks to ensure the “complete, verifiable and irreversible” end to his weapons dabbling, as America has demanded. In 1994 China, Japan and South Korea backed off a tougher stance and America ended up with no real means to check that North Korea was keeping to its side of the bargain (which, it turns out, it wasn't). Now Mr Kim has even thrown out the few international monitors who were casting an eye on the plutonium-laden spent fuel-rods stored as part of that earlier deal. And, his wary eye on toppling statues in Baghdad, he now dismisses all inspections as a pretext for war. In fact the opposite is true. Had Saddam Hussein decided to disarm instead of dissemble, inspections could have demonstrated that credibly years ago, as they did in South Africa after 1993 when that country wanted to show it had given up its secret stash of bombs, and he could have stayed in power. They could help clinch a crisis-ending deal for Mr Kim too, but only—another potential deal-breaker?—if he allows inspectors the poke-about freedom to complete their job.

Then there is the problem of what to do with the weapons and the fissile material that Mr Kim has been boasting about. His 1994 pledges would not have obliged him to come clean about any early bomb-tinkering until a handover of the better part of the promised goodies, which included two western-designed nuclear reactors with a $5 billion price-tag that are still under construction. Mr Kim's new proposals are no more constraining. But who would now trust North Korea with pots of ready-made plutonium or uranium? Under any new agreement these would have to be given up early—not stored in the country, where he can elbow aside monitors and retrieve them easily, but sent outside, perhaps to China.

Too much to ask of prickly North Korea? That depends on whether Mr Kim really is ready to trade in his weapons, or merely trying to string out the diplomacy so he can build more. In testing his true intentions, America will need a lot of help from the neighbours, but above all from China.

China and Russia both could put their diplomats to work on multilateral security guarantees with America that could underpin its assurances, given a number of times, that it has no hostile intent towards North Korea. But North Korea also needs to assure everyone else that its days of brinkmanship are over. Giving up its bomb-usable material is central. But less ambitious confidence-building measures are also needed to reduce military tension at the border with South Korea, and to avoid naval clashes in disputed waters. Meanwhile, South Korea and Japan have both offered huge dollops of aid for Mr Kim's rickety economy. Something there to discuss while the harder security aspects of a deal are being hammered out, so long as he is told plainly that no deal means no help either.

And if Mr Kim drags his feet and hangs on to his weapons? Then he should be told to expect isolation and containment. Though it has no interest in seeing a nuclear North Korea, China has always balked at sanctions (and South Korea and Japan have never been keen). Yet the stakes this time are explosive. China has already put aside past indifference and joined the talks with America and North Korea. Some say it flicked off the oil taps earlier this year to get the recalcitrant Mr Kim's attention. But it may have to get tougher yet.

Mr Kim feeds his nuclear habits with all sorts of dubious sales and financial dodges—from small arms to missiles, from counterfeit dollars to drugs (while others, including America, still feed his hungry people with food aid). All these activities can be cracked down on hard. The best way would be through a UN resolution that gave any government the right to stop and search suspect cargoes going to or from North Korea. And why would America go back to the UN, after the debacle over Iraq? Because both Russia and France this time have hinted at new toughness in the face of a determinedly nuclear North Korea. And China? It will not want to see things go so far. All the more reason to press Mr Kim to kick his nuclear habit early.

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Israel and the Palestinians

George Bush's risk for peace

May 1st 2003
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America's next challenge is Israel

AP

IT IS the end of one stage, for sure. Whether it is the beginning of another is less certain. America's military presence in Saudi Arabia, now about to be cut off, was a prime cause for the Saudi anger that fuelled the terrorism of September 11th. Any reason for keeping the bases—which, with the Saudis insisting on a UN licence, were of limited use in the Iraq war—has vanished along with Saddam Hussein. In these days of democracy and regime change, the Americans are hardly in the business of defending the Saudi rulers or Saudi oil against domestic dissidents. And, for the Saudi government, the bases have become a liability as it slowly responds to the discontent.

Good riddance to them. But what now? A new Middle Eastern era for George Bush would be one in which he turns, with full heart, from the Gulf's dictators to the contortions of Israel and Palestine. He has promised to give the search for a solution his attention. His credibility, in the Arab world and beyond, depends on his keeping that promise, steadily and robustly. The coincidence that this week the famous road map (the outline of a peace process drawn up by America, the EU, Russia and the UN) entered the public domain gives Mr Bush a splendid chance to show that he means what he says.

In summary, the road map is a three-phase blueprint for ending the conflict in 2005. It calls, first, for a return to the situation before the *intifada* broke out in September 2000; second, for the setting up of a Palestinian state with provisional borders; third, for a final negotiated agreement. The map, with its committee of cartographers, is a pretty imprecise document, but, for the first phase, it has clear demands: it calls on the Palestinians to end their violence unconditionally, and it simultaneously calls on Israel to start reopening the reoccupied areas, and to freeze all its settlement activity.

The Palestinian Authority has said that it accepts the map as it is. The assurances of the new prime minister, Mahmoud Abbas, that he will do all he can to end the violence are reasonably credible, though the problems were cruelly underlined this week with a suicide bombing in Tel Aviv. Israel's prime minister, Ariel Sharon, has showered the map with conditions. In particular, the Israelis insist on Palestinian violence being brought to a decisive end before they make a move.

The Bush administration is sending mixed messages about such amendments. Sterner officials suggest that though all comments will be entertained, the map is not up for renegotiation. This is not, however, the message the Israelis say they are receiving themselves: their misgivings, they believe, will be taken into account before the map's formal publication, which seems likely to happen some time after this week's submission of the plan to the Israeli and Palestinian governments.

The Israelis expect much coaxing and cajoling from Washington but do not expect the boot to be put in. Vast sums of money could be at stake, but Israelis are confident they will get the cash anyhow. Extra military aid, worth $1 billion , has already been approved; $9 billion of loan guarantees are still being negotiated but so far on economic, not political, grounds.

Be tough, the roof won't fall in

Is Israel's confidence well-placed? If it is, the map may as well be abandoned. Certainly, pressure has to

be kept on the Palestinian Authority to do its utmost to bring the self-defeating *intifada* to a once-and-for-all finish. But the essential and so far missing factor is real American pressure on the Sharon government to take painful steps towards peacemaking.

American officials claim that Mr Sharon's apparent acceptance of a two-state solution by 2005 is such a step. The prime minister has learnt to talk smoothly. But his half-vision of a scrappy Palestinian state in about 40% of the West Bank, while Jewish settlements and their environs gobble up most of the rest, is nobody else's idea of a viable country, while his conditions, above all his insistence that Israel should do nothing until after a period of quiet, may block any movement at all. The abnormality of Palestinian life, with 53% of the workforce unemployed, feeds the violence. It is crucial that Israel should start reopening the country. Even more important, it must put an end to the non-stop burgeoning of Jewish settlements.

Mr Bush, if he is really now exchanging his brass hat for a peacemaking boater, must insist that Mr Sharon obey the road map's injunctions both on normalisation and on a settlement freeze. If America is serious about this, Israel cannot for long defy it. And nothing terrible need result. If Mr Sharon loses the right-wing parties in his coalition, he can renegotiate with the Labour Party. Nor is it axiomatic that a Bush-Sharon tussle would lose America's president the Jewish vote: if Israeli opinion were sharply divided over American peacemaking, American Jewry would probably split too. But, first, Mr Bush, who risked war, has to decide to take a risk for peace.

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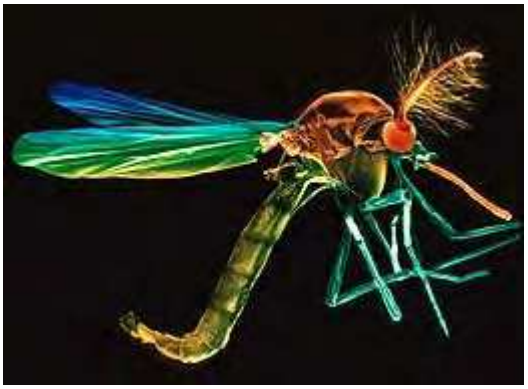
Malaria

Africa's other plague

May 1st 2003
From The Economist print edition

More money, and fewer taxes, are needed to fight one of the world's top killers

Alamy



IF SEVEN Boeing 747s, filled mostly with children, were crashing into Mount Kilimanjaro each day, something might be done about it. That, in the memorable phrase of Wen Kilama, a Tanzanian researcher, is roughly the scale of the carnage wrought by one disease, malaria, mainly in Africa. The suffering is worse than the imaginary flock of air disasters, though, because it afflicts hundreds of times more people than it kills, and because the cost of treating it impoverishes hundreds of millions. Odd, then, that so little has been done to curb it.

In the 1950s and 1960s, malarial mosquitoes were beaten back in much of Asia and Latin America, largely through the use of DDT. Hundreds of millions of human lives were saved, albeit at a cost to birds and animals, and DDT remains a useful tool in places that can afford it. But this excludes most of Africa, where malaria finds 90% of its victims (see article).

Most of the money Africa spends on fighting malaria is private, not public. When people feel feverish, they reach into their pockets and buy anti-malarial drugs. If their pockets are empty, they just have to hope that their immune systems are in good working order. Often they are not.

This will not do. Malaria requires a collective response, not only for compassionate reasons (the disease hurts poor children the most), but also because some of the tools for battling it show increasing returns. If one person sleeps under an insecticide-treated bednet, for example, he gains some protection against mosquito-bites, and so against malaria. If everyone in the village has a net, however, each net provides greater protection, as the collective whiff of insecticide kills more mosquitoes and prompts others to stay away.

African health budgets are minuscule, but international aid could help. By one estimate, deaths from malaria could be cut in half by 2010 and cut in half again by 2015 for $1.5 billion-2.5 billion a year. The UN says that, since 1998, when it launched a campaign to Roll Back Malaria, the funds available to fight the disease have tripled to $200m a year, and will rise further when the UN's Global Fund to fight AIDS, TB and malaria is up and running. Some question these numbers. Amir Attaran, a Harvard academic, calculates that rich-country donations to the cause have stagnated, at $100m annually, if private donors such as the Wellcome Trust are excluded.

Cheap and effective

Whether Dr Attaran is right or not, the sums so far committed fall far short of what is needed. There are several proven, cost-effective techniques for curbing malaria, none of which is as widely used as it should be. Less than 5% of African children enjoy the protection of an insecticide-soaked bednet, for example, and only 15% sleep under any kind of net. Most pregnant African women visit an antenatal clinic at least once, but too few are prescribed the two large doses of anti-malarial drugs that the World Health Organisation recommends to protect both mother and baby. More public money should also be spent on the search for new treatments, to tackle drug-resistant strains of the disease, and to find a vaccine. The latter quest depends far too much on a single (generous) donor, Bill Gates.

African governments need to take malaria more seriously, too. Some do, notably Tanzania and Eritrea.

But 26 of them continue to tax the importation of bednets, which few manufacture domestically. Making life-saving devices more costly is hardly a rational health policy.

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The rule of law in Iraq

Who should try the Saddamites?

May 1st 2003
From The Economist print edition

America has rejected the idea of an international tribunal. It is mistaken

Getty Images

Get article background

TERROR was the principal tool of Saddam Hussein's regime. In war, his forces flouted any constraints, employing poison gas, mistreating prisoners and devastating occupied Kuwait. At home, his government crushed real or imagined opponents, using torture and murder on a wide scale. Saddam and his henchmen believed that they would never have to answer for their crimes. But with a growing number of top Iraqi leaders now in American custody—including Tariq Aziz, the regime's suave public face—a reckoning approaches (see article). How they should be brought to justice is a complicated and politically charged question. Unfortunately, it looks as if the United States is about to come up with the wrong answer.

Bush administration officials describe two categories of crimes attributable to Saddam's regime: crimes of war committed against American forces during the recent fighting and in the Gulf War, and those committed in time of both war and peace against others. Those responsible for crimes against American forces—mostly mistreatment of prisoners, false surrenders and the direction of suicide attacks—will be tried by American military courts. This is allowed by the Geneva Conventions, and should not be contentious if the courts are truly independent, although the Americans have to recognise that there will be some scepticism about their intentions after their brushing aside some of the same rules in dealing with prisoners from Afghanistan held at Guantanamo Bay.

But America's current plan for the top leaders of Saddam's regime is far more controversial, and almost certainly a mistake. This is to reject the idea of an international tribunal, and instead to hold trials before Iraqi-only courts. The administration's stated goals are laudable. It rightly argues that the worst crimes of Saddam's regime were against the Iraqi people, and so concludes that they themselves should be the ones to judge their tormentors. Iraqi-controlled trials will also help establish the rule of law in Iraq, claims the administration, providing the cornerstone of a new, sorely-needed legal system.

These are indeed desirable goals, but they are unlikely to be achieved through locally controlled trials of Saddam, if he is caught alive, or his minions. Iraq's judges and lawyers have all been compromised by their own involvement in decades of repression. Returning Iraqi exiles, themselves victims of the regime, would also lack credible impartiality, even in the eyes of most Iraqis. The usual pattern after the fall of dictatorships is the escape of top leaders, revenge killings and kangaroo courts. Such could yet be the turn of events in Iraq. Trials held under American auspices will also be too easy for sceptics, inside as well as outside Iraq, to dismiss as “victors' justice”.

An international tribunal would be a far more effective mechanism for showing Iraqis, and everyone else in the Middle East, the crucial difference between genuinely fair trials, held before impartial judges, and political show trials. Such a tribunal would also provide Iraqis with a clear record of their own history, and help to lift Iraq's fragile experiment with democracy above the recriminations which may yet engulf it.

The International Criminal Court was set up to help countries in Iraq's situation. But it cannot deal with crimes committed before its own founding last July, and in any event America opposes it. Even so, plenty of other options are workable. The special tribunals, presided over by international judges, that are currently trying Yugoslav and Rwandan leaders have proven, after initial hiccups, capable of handling

complicated and emotionally difficult cases. International control does not rule out Iraqi involvement. In fact, another option could be mixed tribunals with a minority of local judges, held in Iraq, like those recently set up in Sierra Leone and East Timor.

The Security Council's asset

In addition to international jurists, the other thing these tribunals have in common is the backing of the United Nations Security Council. Despite all the bickering in the council this spring over how to deal with Iraq, the council retains undisputed legal authority when its members can agree to act together. That authority would be an invaluable asset in the difficult task of establishing the rule of law in Iraq.

Even America's critics in the council would find it difficult to deny this kind of help. If they did, America would still gain credit for seeking it, and wide support if it then went ahead to recruit international judges on its own. Whatever its doubts about UN involvement in other areas, America should swallow them when seeking support for credible trials of the men who, for so long, denied Iraqis any semblance of justice.

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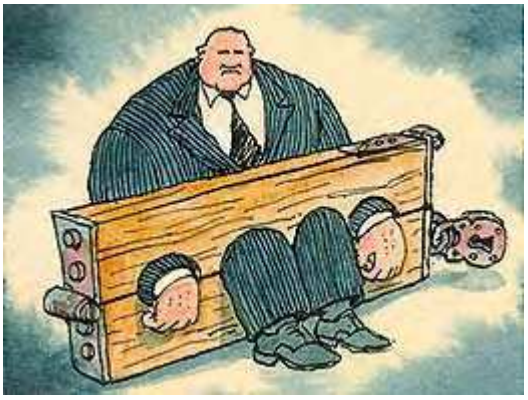
The Wall Street settlement

A sour aftertaste

May 1st 2003
From The Economist print edition

No one has emerged with credit from Wall Street's conflict-of-interest scandal



DUPED? Conned? Cheated? If, like so many Americans, you were buying shares as the stockmarket inflated, bubbled and burst, you might well feel angry now. The three-year bear market has been bad enough, but for months the financial press has oozed stories about what really went on when the bulls were running. All those hot new tech-stocks you chased after? They had already been "spun"—given, if you prefer—to favoured clients of the investment bankers underwriting the issues. All those breathless "buy" recommendations from the analysts in the know? Worthless. The analysts were puffing the shares to win business for their investment-banking chums. Even as they were trumpeting the things in public, they were trashing them in private, often in scatological terms.

The "global settlement" between America's securities regulators and ten investment banks unveiled in Washington on April 28th is supposed to draw a line under this tawdry chapter in Wall Street history (see article). The bad guys have not exactly been led away in chains, but—if you believe America's financial sheriffs—their faces are red with shame, their wallets are lighter and they will mend their ways. The investment banks will pay almost $1.4 billion in fines and financing for "independent" research and investor education. Two fallen star analysts, Henry Blodget and Jack Grubman, face multimillion-dollar fines and life bans from the securities industry. Wall Street has promised a strict division—even physical separation—between its research analysts and the investment bankers who until recently influenced both their published opinions and their pay.

A cleaner Street?

The outcome, however, is less clean and much less satisfactory than the regulators seem to think. In one sense, this is not the end of the affair, merely the end of the beginning. Now that a settlement has been reached, eager lawyers can get to work in earnest on class-action lawsuits on investors' behalf. These suits may well cost Wall Street far more than this week's settlement has done. To make matters muddier still, it is still not clear what the investment banks have done wrong, legally speaking. If the law was broken, then firms and their employees should have been prosecuted. If it was not, then the fines and bans seem hard to justify. Yet so far only one investment banker is facing criminal charges, and that in a separate investigation. In the main action, covered by this week's settlement, charges were levelled, and the cases and penalties settled, without anyone admitting or denying anything, and without anything being proved.

What is worse is the roughness of this week's justice. Admittedly, few tears should be shed for Mr Blodget and fewer still for Mr Grubman. Despite the fines and the bans, they still have several million dollars to console them. Nonetheless, there is little doubt that they are convenient scapegoats for the firms that employed them and for the rest of the industry. Wall Street's top bosses—notably Sandy Weill, the head of Citigroup, Mr Grubman's former employer and the most heavily fined of the Wall Street firms—have suffered little more than bruised reputations. Instead of paying for their firms' transgressions with their jobs, they have paid with a few hundred million dollars of shareholders' money. Yet when these men earn so many millions, the buck should stop at the top, not a few rungs down.

At least, surely, the regulators should take some credit? Only up to a point. It would have been better

had the investigation been conducted at a federal level. Yet the Securities and Exchange Commission (SEC), supposedly the chief regulator, was slow to look into the investment banks' behaviour. That allowed state attorneys-general to step in. The outcome has been the mild shaking-down of Wall Street; yet what matters to investors is the effectiveness of its shaking-up. If the regulators truly believe that the main element of their structural reforms, the separation of equity research from investment banking, will remove Wall Street's inherent conflicts of interest, they are mistaken. The industry's conflicts cannot be regulated away. It may be better to accept that they exist, but to insist that they be disclosed. One way or another, in-house research will have to pay for itself—perhaps implying a subtle erosion, somehow, of the new, strictly drawn dividing line between research and investment banking. If it does not, it will be wound down. Indeed, Wall Street already employs far fewer analysts than it did, often at much lower salaries.

All of which gives you, the angry investor, plenty of people to blame. Plus, of course, yourself. The likes of Mr Blodget and Mr Grubman may have told you fibs. The SEC may have been slow off the mark. But your money is your own responsibility, no matter what honey-tongued lawyers tell you.

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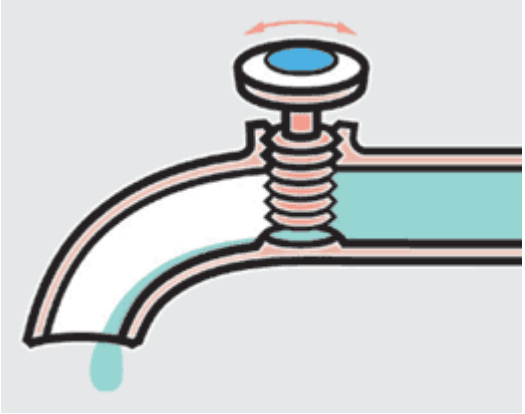
Global finance

A place for capital controls

May 1st 2003
From The Economist print edition

For many developing countries, unrestricted inflows of capital are an avoidable danger



IF ANY cause commands the unswerving support of *The Economist*, it is that of liberal trade. For as long as it has existed, this newspaper has championed freedom of commerce across borders. Liberal trade, we have always argued, advances prosperity, encourages peace among nations and is an indispensable part of individual liberty. It seems natural to suppose that what goes for trade in goods must go for trade in capital, in which case capital controls would offend us as violently as, say, an import quota on bananas. The issues have much in common, but they are not the same. Untidy as it may be, economic liberals should acknowledge that capital controls—of a certain restricted sort, and in certain cases—have a role.

Why is trade in capital different from trade in goods? For two main reasons. First, international markets in capital are prone to error, whereas international markets in goods are not. Second, the punishment for big financial mistakes can be draconian, and tends to hurt innocent bystanders as much as borrowers and lenders. Recent decades, and the 1990s most of all, drove these points home with terrible clarity. Great tides of foreign capital surged into East Asia and Latin America, and then abruptly reversed. At a moment's notice, hitherto-successful economies were plunged deep into recession.

These experiences served only to underline the lesson of previous financial debacles. Yet it is a lesson that governments remain decidedly reluctant to learn. Big inflows of foreign capital present developing countries with a nearly irresistible opportunity to accelerate their economic development. Where those flows are of foreign direct investment, they are all to the good. But in other cases, disaster beckons unless a series of demanding preconditions are met first (see our survey). A flood of capital into an economy with immature and poorly regulated financial institutions can do more harm than good.

Unquestionably, developing countries should strive to improve their financial systems so that foreign capital can be successfully absorbed. Good government, sophisticated financial firms, and regulators who are honest and competent cannot eliminate the risk of financial calamity altogether, but they can reduce it to bearable proportions. At that point a liberal regime for international capital makes sense. The trouble is, many developing countries are nowhere near that point.

Rich-country governments and, until recently, the International Monetary Fund have often seemed reluctant to endorse this notion. One might say the same of *The Economist*. This reluctance is defensible. Often, indeed typically, governments have abused capital controls in ways that oppress their citizens and do grave economic harm. It seems safer to frown on any and all controls—and, in those cases where they have been used intelligently and successfully, to acknowledge any success very grudgingly. But this is dishonest. It is better to face up to the case for such rules in some circumstances, and think hard about how to use them sensibly, with restraint.

In from the cold

Experience suggests some rules. Refrain from blocking capital outflows (tempting as this might be at times of crisis). Such measures are usually oppressive, and deter future inflows of all kinds. Poor countries need all the foreign direct investment they can get: let inflows of FDI be unconfined. Other long-term inflows also pose little threat to stability. The chief danger lies with heavy inflows of short-term

capital, bank lending above all. These can be difficult to stem, but many developing countries would do well to emulate the successful experience of Chile, which has imposed taxes on such inflows, with the rate of tax varying according to the holding period.

In negotiating new free-trade arrangements with Chile (and with Singapore), the United States has recently sought assurances of complete capital-account liberalisation. Bitter experience suggests that such demands are a mistake. It is past time to revise economic orthodoxy on this subject.

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Europe's single currency

Britain and the euro

May 1st 2003
From The Economist print edition

The government's policy is to delay the inevitable. How wise

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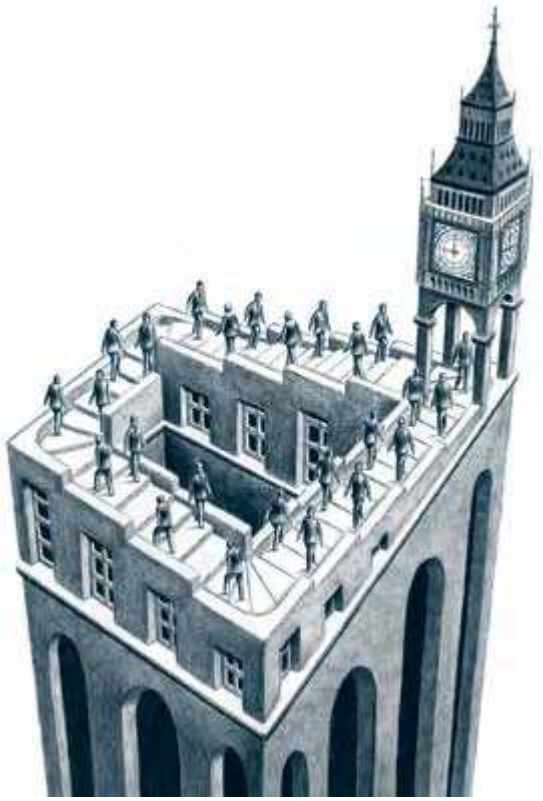

IN OPPOSITION, Tony Blair used to mock the Tories' vacillating policy of “wait and see” on the euro. What kind of leadership was that, for heaven's sake? Labour's approach on coming to power would be much more manly and purposeful: instead of “wait and see”, a new policy of “prepare and decide” was unveiled. Admittedly, “prepare and decide” would be an odd strategy for, say, building a house: clear the site and put in the foundations, then decide whether you want the house. But at least it would involve doing something, and that was the main thing.

Six years on, the preparations are not much in evidence and the decision seems about to be postponed again. Give the government its due, however. There has been lots of activity. Labour's approach, unlike the Tories', reflects countless man-hours of Treasury toil and thousands of pages of supporting analysis. When this government concludes that it had better wait and see, it really knows what it is talking about.

Verdict of convenience

Gordon Brown, the chancellor of the exchequer, will shortly announce the results of all that furious analytical effort in the form of a verdict on his “five tests” (see article). The prime minister is keen in principle to take Britain into the euro system—but this should happen, says the less-keen chancellor, only when the tests have been satisfied: when inflation and interest rates have converged with conditions in the euro area, when Britain and the euro economies are flexible enough to get along without the shock absorber of their own exchange rates, when Britain's investment prospects as a member look positive, when the City is positioned to thrive under the new regime, and when the overall implications for “jobs and prosperity” are favourable.

The chancellor has framed his tests so vaguely that he can announce that the economy has passed or failed any or all of them more or less on demand. The government, as a matter of political calculation, is not yet ready to put the issue to the British electorate. Therefore Mr Brown is expected to rule that more time is needed to satisfy all his criteria. Actually, this is fine. “Wait and see” still makes excellent sense. The only flaw is that the economic tests that ought to be satisfied before Britain joins are rather different from those on Mr Brown's list. There are three.

First, the sensitivity of the economy to changes in interest rates needs to diminish, so that it is closer to the euro-area average. This has little to do with the current level of interest rates (included in Mr Brown's tests). The question is how abruptly the economy responds to *changes* in interest rates, remembering that once Britain adopts the euro its rates will be set not with Britain's conditions exclusively in mind, but according to conditions on average across the whole of the euro area. At present Britain is much more sensitive to changes in interest rates than most other European economies because of its preponderance of floating–rate mortgage debt. This in turn is a legacy of the high inflation of previous years: people bought houses on credit as a hedge against rising prices, and banks and building societies lent at floating

rates rather than fixed because of uncertainty over the future course of monetary policy. Low inflation will gradually erode this difference, but joining the euro system before the change is well advanced would be risky.

Second, the European Central Bank (ECB) needs to be given a different mandate. Rather than being told to achieve “price stability” and left to define that objective for itself, it should be given an explicit inflation target by the Council of Ministers (in the same way that the Bank of England is set an inflation target by the Treasury). The ECB has not distinguished itself as a good judge of monetary policy, but this is partly because it has set itself an unduly strict operational target for inflation: it aims for inflation of 2% or less (rather than the Bank of England's 2.5%, with a margin above and below).

Third, Europe's inept Stability and Growth Pact should be improved, preferably to the point where it ceases to exist. Flexibility in fiscal policy is of paramount importance once economies lack control of their own interest rates. The pact insists that fiscal deficits stay small even when economies are in recession. Germany's attempts to comply with these rules (introduced at Germany's insistence, by the way) are even now retarding its recovery from a needlessly prolonged slowdown.

Rival visions

Once these tests have been met—and there is no reason why they should not be—the economic benefits of Britain's adopting the euro would most likely outweigh the economic drawbacks: the gains from fiercer competition within the European market and the spur to cross-border investment would more than make up for the loss of exchange-rate flexibility. But the choice is only partly, and secondarily, a matter of economics. Joining the euro system is also an act of commitment to a political cause—that of deeper European integration.

Britain's euro-enthusiasts emphasise that the country cannot play its rightful leadership role at the centre of the European Union unless it takes up the new currency. In fact, that is debatable, but even if it were true, one would still need to ask whether Britain should want to exercise such a role. The answer depends on what political form the emerging new Europe takes, and this remains much in doubt. Radically different visions of Europe's future—a Europe of independent nations, or a United States of Europe—are still in contention. Should Britain want to be at the centre of Europe regardless of what Europe decides to become?

A constitutional convention is drawing up a design for Europe's political future. The signals emerging from this body have been mixed; the Union's future shape is far from clear. Nonetheless, when Britain assents in due course to a new EU constitution, the country will be choosing how deeply embedded in Europe it wishes to be. At that point, one more reason for hesitating on the euro expires. “Wait and see” is not for ever, but it will do just fine for now.

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Letters

May 1st 2003
From The Economist print edition

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California seething

SIR – What a flaming asshole. Lexington's remarks are an excellent example of the sort of daft, ill-considered and deficit-braincell horse-exhaust that *The Economist* permits with increasing frequency in its pages (April 12th). "California has been out of the loop ever since the Clintons moved out of the White House"? If anything, the reverse is true. The rest of the nation has once again reverted to the mindless mindset of cold-war-style imperialism, now that George Bush and his gang of corporate sheep-dawgs are in charge of the most fearsome arsenal of weaponry ever known to humanity.

Oil? Important, yes, but not as important as the stupidly naive neo-conservative philosophy underpinning America's recent aggressions. Lexington's arrogance is breathtakingly sophomoric and insulting.

Thank God he's not a member of Mr Bush's cabinet; they have enough myopic, right-wing idiots as it is.

C.T. Carey
Sacramento, California

SIR – You seem to think that Washington and New York comprise the entire east coast. People in Boston, Philadelphia, Richmond, Atlanta and Miami also witnessed the events of September 11th only on television. The extra thousands of miles to California made little difference on the impact on viewers.

Tom Harley
Palo Alto, California

SIR – You couldn't be more wrong about California. Bathed in sun or not, we are as frantic about security here as just about anybody.

You say that we are "out of the loop" politically? If by that you mean Dubya doesn't take our calls, that's true. Like most American voters, we wanted Al Gore for president. Our Democratic Party is not, as you claim, in the hands of the extreme left. California Democrats are centrist, pro-free trade and pro-business. We are also environmentalist, fiscally conservative and pro-choice. We are out of step with the White House and Congress on those issues, but in step with the majority of Americans.

Andrew Okun
Los Angeles

SIR – You chide "yet another degree-less actor" for subjecting us to his views on Iraq. Still, one cannot help but wonder what would happen if degree-less people were given the vote. Why, perhaps even George Bush could become president.

Greg Parnell
Seattle

China and SARS

SIR – Your article is as timely as it is enlightening ("China's Chernobyl?", April 26th). The dreadful spread of SARS in China is not just a health concern, but an example of the consistent deception, lies and cover-

up practised by the Beijing regime over the past 50 years. As a matter of intellectual hygiene, more exposure on the AIDS epidemic, labour unrest, and the persecution of religious groups such as Christians and the Falun Gong should be made as well. Insightful articles like yours will help bring transparency to the Chinese government, a critical step toward political reform in the “Middle Kingdom”.

Erping Zhang
Association for Asian Research
New York

SIR –SARS is a sudden and severe disease unknown to mankind before now. As the first victim struck by this epidemic, China has suffered great loss in terms of human life and economic growth. The Chinese government and people have mustered all resources and spared no effort to combat this disease.

In contrast with the kind sympathy shown by the British government and people, *The Economist* seems most unsympathetic and even sarcastic about China's misfortune. When the international community is working closely to combat SARS, an epidemic which presents a challenge not only to China, but to the whole world, it is most inappropriate to make false and groundless accusations about China cooking up nasty viruses to unleash. It is time to stop hurting the feelings of the Chinese people when China is in difficulties.

Lu Wenziang
Press counsellor
Chinese Embassy
London

Financing dissidents

SIR – Your article contains some inaccuracies (“Castro cracks down”, April 12th). This is, by far, the harshest crackdown on the dissident movement in Cuba in over 20 years. Fidel Castro's opponents have not faced such long prison sentences since the 1970s and contrary to your report, most opposition is now based in Cuba, not Miami.

The White House has, on several occasions, linked the lifting of the trade embargo with political reform in Cuba—most recently by President Bush himself, during a speech celebrating Cuba's independence day in May 2002.

It is interesting to see your newspaper call for sanctions against Mugabe's regime, yet promote trade with Castro's.

Sebastian Arcos
Miami, Florida

SIR – America not only gives moral support to the dissident movement in Cuba, but money as well. This not only gives Fidel Castro a “rhetorical pretext” for his actions but also gives dissidents a veneer of illegitimacy. To ensure this effect, the Cuban government has even provided believable details of financial transactions between dissident members and American entities, supplied by moles within the organisations. The charge is that dissidents are subservient to a foreign power for the sake of money.

If any dissident movement in Cuba is ever to succeed, it will have to be scrupulously home-grown. The sooner the American authorities realise this, the better the chances of eventual success.

Ed Canler
Chattanooga, Tennessee

Biblical mastery

SIR – The authors of the King James Bible may have indeed created a masterpiece but the example you give is not an indication of their mastership (“The language of light”, April 19th). Changing the translation from “upon the deep” to “upon the face of the deep” (and to “upon the face of the waters”) is no great accomplishment. It is an accurate translation of the Hebrew text; the language in which the Bible was originally written.

Asher Gabbay
Tokyo

Toyland pedigree

SIR – I am not clear by what logic you use Ariel's race (mermaid) to negate her royal pedigree and so her place as a Disney “Princess” (“A challenge to Barbie”, April 19th). As the daughter of King Triton and the bride of Prince Stefan surely she qualifies on two counts? Aurora, Snow White, Pocahontas and Jasmine were also born royal, although the latter two married beneath themselves. Both Cinderella and Belle had to marry for their titles.

The odd one out is Mulan, daughter of an army officer and future wife of a general. Of course, as the principal architect of the defeat of the Huns perhaps she qualified on merit? Which makes me curious: why would Disney, icon of republican America, choose to promote “Princess” over “Heroine” as a brand?

Niall Creed
Leighton Buzzard,
Bedfordshire

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North Korea

When bluff turns deadly

May 1st 2003
From The Economist print edition

If diplomacy cannot work, what then?

Get article background

WITH its bomb now out of the basement and on the front porch, will North Korea's nuclear ambitions be any easier to deal with? It helps a bit, said Colin Powell, America's secretary of state, earlier this week, that North Korea has acknowledged more of what it has been up to. But apparently it won't help much. North Korea not only told American diplomats informally at talks last week in Beijing that it already possesses nuclear weapons, but this week strongly implied that it had deployed them, ready for use.

As more of the details of last week's talks between America, North Korea and China leak out, Mr Powell seemed to be offering not so much a glimmer of hope, as an indication of how difficult it will be to resolve the nuclear stand-off peacefully, and by diplomatic means. George Bush, for his part, has already said that North Korea is back to its bad old habits of threats and “blackmail”.

In Beijing, North Korea did offer eventually, if somewhat belligerently, to give up both its bombs and its missiles. But it demanded in return a set of conditions that American officials say amount to a complete non-starter. By all accounts North Korea wants to hang on to its weapons until the end of a process in which America would take the first steps—to guarantee the regime's survival and to hand over oil, energy assistance and much else. “We're not going to pay for the elimination of nuclear-weapons programmes that never should have been there in the first place,” insisted the State Department's spokesman, Richard Boucher.

North Korea, for its part, has accused America of playing a “mean trick” with its bomb-building admission, and has been threatening all sorts of dire but unspecified consequences that have led some observers to think that it may be preparing to test one of its bombs, just to make its point. To put it mildly, therefore, the chances for a negotiated outcome do not look good.

Might they improve? That depends on whether not just America, but also others, including China, can persuade North Korea that the alternative to giving up its bombs would be a lot worse.

To the brink

America insists that, while its line on talks with North Korea is tough, it is also realistic. Its aim, say officials, is a “complete, verifiable and irreversible” end to North Korea's nuclear ambitions. The preferred alternative policy, one long favoured by hardliners inside the Bush administration, is likely to be isolation and containment.

They point out that deals have been done with North Korea before, only to be broken. America has long suspected that, before a 1994 deal that was supposed to have frozen and ultimately ended North Korea's illicit plutonium production and returned it to full compliance with the Nuclear Non-Proliferation Treaty (NPT), its weapons-builders had squirrelled away enough plutonium for perhaps one or two bombs. But under the 1994 agreement, investigation of all that was deliberately set aside to await the arrival of nuclear components for two western-designed nuclear reactors. These are still being built in North Korea, at a cost of $5 billion that is chiefly being met by South Korea and Japan.

This is the deal that North Korea had been violating, possibly for four or five years, when the latest crisis began. Last October, America's diplomats presented their North Korean counterparts in Pyongyang with evidence showing they knew that the North had secretly started up a second potential weapons programme—this one relying on uranium-enrichment technology that North Korea appears to have obtained covertly from Pakistan in return for North Korean missiles and technology.

Since then, North Korea has thrown out weapons inspectors from the International Atomic Energy Agency who, as part of the 1994 agreement, were watching over a stash of spent fuel-rods at North Korea's single working nuclear reactor at Yongbyon; has restarted the mothballed reactor; has removed the seals on the stored fuel-rods, and is either about to start or about to finish (depending on which translation of its recent statement on the subject you choose to believe) extracting their bomb-usable plutonium, sufficient for another five or six bombs. (In reserve it has two more reactors of its own, still to be completed, that will eventually provide a steady supply of enough plutonium-laden spent fuel for tens of bombs a year.) In January it announced—without observing the formal three-month notice period—that it had quit the NPT.

North Korea’s missile threat

Type	Maximum range	Payload	Status
Nodong	1,300 km (810 miles)	700 kg (1,550 pounds)	Currently deployed
Taepodong-1	Up to 10,000 km	Several hundred kg	Test failed 1998, not yet operational
Taepodong-2	10,000–15,000 km	Several hundred kg	Not yet tested

Source: Task Force for US Korea Policy, Centre for International Policy

All this, North Korea's official news agency said this week, was to “deter” mighty America. The United States should give up its weapons, said the statement, “before such a small country as [North Korea] does.”

So now what? Before the talks, American officials had insisted that any attempt by North Korea to

reprocess the spent fuel-rods at Yongbyon would “change the picture entirely”. Yet, by admitting to having bombs and being ready to use them, North Korea has in effect already changed it (though, intriguingly, American officials still say they have no confirmation, despite North Korea's bluster, that any rods have actually been reprocessed). China, which not only hosted last week's talks, but also took part in them, advised everyone not just to watch what was being said, but also what was being done. Was this a warning to North Korea against further provocative action, or advice to America not to take North Korea's bluster at face value?

Certainly America will now need to consult with others involved, especially its close allies, South Korea and Japan, but also with China and Russia, about whether, and if so how, to take the diplomacy forward. Until just before the Beijing talks, North Korea had insisted that it would sit down only with America to discuss the nuclear issue. But it eventually gave way (quite possibly under heavy Chinese pressure). It had previously insisted that it would not discuss a “comprehensive” security package with America either, but in its offer to deal with bombs and missiles together, it seemed to give way a little on that too. Might there yet be scope for a deal?

Pressure from enemies, and friends

If there is, that hope lies in the multilateral framework that the Bush administration has insisted on, and in particular on whether China takes an even more active and helpful part in the diplomacy. Suspicious that North Korea would simply use talks to buy more time to build more weapons, and determined that other countries with an interest in the nuclear issue be involved in keeping North Korea to any future deal, America had at first insisted that South Korea and Japan have a seat at any talks too. The tripartite discussions in Beijing involving China, the closest North Korea has to a semi-friend, were a face-saving formula. They were also a breakthrough, since China has in the past shied away from any hint of pressure on North Korea, at least in public.

But this time the stakes for China are high. It does not want to see the North Korean regime collapse, since that would drive hundreds of thousands more hungry refugees across its border (where possibly as many as 200,000 North Koreans are living illegally already). But China knows that a nuclear-armed North Korea, unchecked, could provoke an unwelcome response from its rival, Japan. In late February it is reported to have turned off the oil taps on North Korea for two or three days to encourage it to tone down its belligerence. Might it now do more?

As North Korea steps up its threats, China will have increasing reason to do so. The unannounced launch of a North Korean rocket over Japan in 1998 had already galvanised opinion there and, to China's alarm, has pushed the Japanese government to co-operate more closely with America on missile defence. North Korea's recent nuclear taunts have damaged China's interests too, and not just by reminding Japan of the value of the America-Japan security alliance. Japan's defence officials have started to consider what additional weapons they might need to deter North Korean aggression. Some right-wing members of the ruling party have started asking whether Japan, too, should now have its own nuclear option. Nor is Japan the only country in the region capable of going nuclear at speed: both South Korea and Taiwan have in the past had nascent nuclear programmes, and in each case abandoned them only under American pressure.

All this is enough to give Chinese officials nightmares. Thus far, they have been reluctant to let the North Korean issue go to the UN Security Council for action, including possible sanctions. Russia has been reluctant, too. Last month the council discussed North Korea's pull-out from the NPT, but could not manage even a joint statement condemning the move. Since then, however, Russia has suggested that if North Korea pursues its nuclear option much further, it would be prepared for tougher action. That might encourage China to take a tougher line, too.

But these are not the only countries that would be reluctant to see sanctions imposed on North Korea. So would South Korea. Its new president, Roh Moo-hyun, had at first hoped to continue the “sunshine” policy of his predecessor, Kim Dae-jung. And while he has insisted that the Korean peninsula remain nuclear-free, he has also ruled out, as America has not, the use of force to achieve that. But would he rule out sanctions too, if it came to it?

North Korea has long said that it would regard any kind of sanctions as an act of war, and would respond accordingly. But unless the prospects for diplomacy quickly improve, such issues may well be on the agenda when Mr Roh visits Washington, DC, shortly for his first meeting with Mr Bush. South Korea was an early supporter of America's war in Iraq. But Seoul, the South Korean capital, is within artillery range

of North Korea's guns dug into the hills just across the Demilitarised Zone that forms the border between the two countries, and this makes any South Korean government ultra-cautious in its dealings with the North.

This week South Korea's unification minister, Jeong Se-hyun, returned from North Korea without a hoped-for conciliatory statement on the nuclear issue. Mr Jeong had told the North Koreans that the crisis was harming South Korea's economy, and had hinted that further rice aid would be conditional on better behaviour. For its part, North Korea has been trying hard to drive a wedge between South Korea and America, this week referring to American troops in South Korea as a “cancer”. In the past, and in private, some South Korean officials have hinted that it might be better to live quietly with a nuclear North Korea rather than push it to collapse. But North Korea has made living quietly with its bomb an option no longer.

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North Korea's economy

Desperate straits

May 1st 2003 | BEIJING
From The Economist print edition

Only China keeps things going

Get article background

FOR some time now, North Korea's economy has been close to meltdown. In July last year, the regime tried desperately to resuscitate it by adjusting prices and wages to make them reflect market realities. The result has been rampant inflation that has made life even more miserable for most North Koreans, except the Pyongyang elite. Millions are suffering from acute shortages of food caused by industrial collapse.

Donor fatigue is making it ever harder for the World Food Programme (WFP) to help the worst-affected—mainly those living in the cities, home to 65% of the population. Malnutrition is widespread. Even in Pyongyang, citizens have turned any unused patches of land into tiny plots for maize or vegetables. The shelves of state-owned shops are virtually empty. Embarrassed officials keep visitors away even from the department store that used to be the regime's showcase.

Conditions are not as bad as during the famine of the mid-1990s, when hundreds of thousands died of starvation, but they are “daily getting worse”, says a Pyongyang-based diplomat. “There is a school of thought”, he adds, “that central rule has broken down.” Officials in the capital often deny there is anything wrong, but in the provinces “there is far more readiness to admit to shortcomings and shortages.” Two west Europeans, visiting as guests of the government, were taken recently to a hospital south of Pyongyang; it turned out to be the only one, in an area serving 1.6m people, that was equipped to handle major operations. Officials accompanying the visitors became “very, very nervous” when hospital staff let slip that their two ambulances were no longer usable.

But those who count most to the country's leader, Kim Jong Il—the armed forces and the bureaucrats—manage to get by. They draw income from a few brave foreign investors (mostly South Korean), remittances from ethnic Koreans in Japan (though Japan's economic woes have reduced these) and the country's shadowy trade in everything from missile technology to fake banknotes and narcotics.

The privileged, with access to foreign currency, fare best. In July, the official exchange rate of the North Korean won was revised from 2.15 to the dollar to 150. The black-market rate is now rumoured to be closer to 800. (In North Korea's highly secretive and closely monitored society, of course, such data are extremely hard to verify.) Wages increased by 20 times or more after the July reforms, but prices have gone up by even wider margins. The reforms were supposed to give enterprises greater responsibility for their balance-sheets: bigger profits could, in theory, mean bigger wages. In practice, hardly any factory in the country can turn a profit. Energy and fuel shortages are crippling, the cost of inputs is soaring, and the economy has been reduced to little more than trade in absolute necessities.

For all its pride in the philosophy of *juche*, or self-reliance, North Korea is heavily dependent on its giant neighbour, China. Without China's oil supplies, which amount to about 70% of North Korea's consumption, the armed forces—upon which the government depends for its political survival—would be unable to function. China's food and other aid also play a big role in propping up Mr Kim. Unlike food donated by capitalist countries through the WFP, China's large offerings are not monitored to see who ends up enjoying them. If apparatchiks are the chief beneficiaries, China doesn't complain.

Earlier this year—the exact dates are uncertain—China made it clear who was really master of the North Korean economy. For three days, say western diplomats, it shut down a pipeline carrying oil across the Chinese border to its impoverished neighbour. China blamed technical difficulties. To the leadership in Pyongyang, however, familiar with the coded signals of its communist ally, China was bluntly showing its

unhappiness at North Korea's escalation of tensions with the United States.

It is difficult to gauge the extent to which China's warning helped bring about last week's negotiations in Beijing. North Korea has appeared remarkably cavalier in its dealings with its chief economic benefactor in the last few months. It failed to secure China's blessing before trying to set up a capitalist enclave on the border between the two countries last September (China showed its displeasure by arresting the Chinese-born businessman appointed by North Korea as the zone's leader on tax-evasion charges). It also neglected to consult China before revealing to the Americans last October that it had a uranium-enrichment programme.

North Korea resents having been forced to depend so much on China since the collapse of its other main benefactor, the Soviet Union (Russia is now a mere bit-actor in North Korea's economy). There is some allure, therefore, in a solution to the current stand-off that would allow American, Japanese and South Korean aid and investment to flow in more freely and thereby reduce North Korea's reliance on China. But Mr Kim's strategy is unlikely to have been much affected by the plight of his people.

Optimists argue that a North Korea confident that it will not be attacked by the United States would be more prepared to scale down its massive military spending and devote more resources to building the civilian economy and attracting foreign investment. But diplomats in Pyongyang see little evidence that North Korea grasps what needs to be done to lure foreign capital, including the massive investment needed in the country's backward and tattered energy, transport and communications systems. “Their solution to any cash-flow problem is to milk the foreigners,” says one. The economic dividends of any peace pact will be a long time coming.

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The Democrats

And they're off

May 1st 2003 | WASHINGTON,DC
From The Economist print edition

This weekend, all nine Democratic presidential candidates gather for a televised debate in South Carolina—the first set-piece of the 2004 election

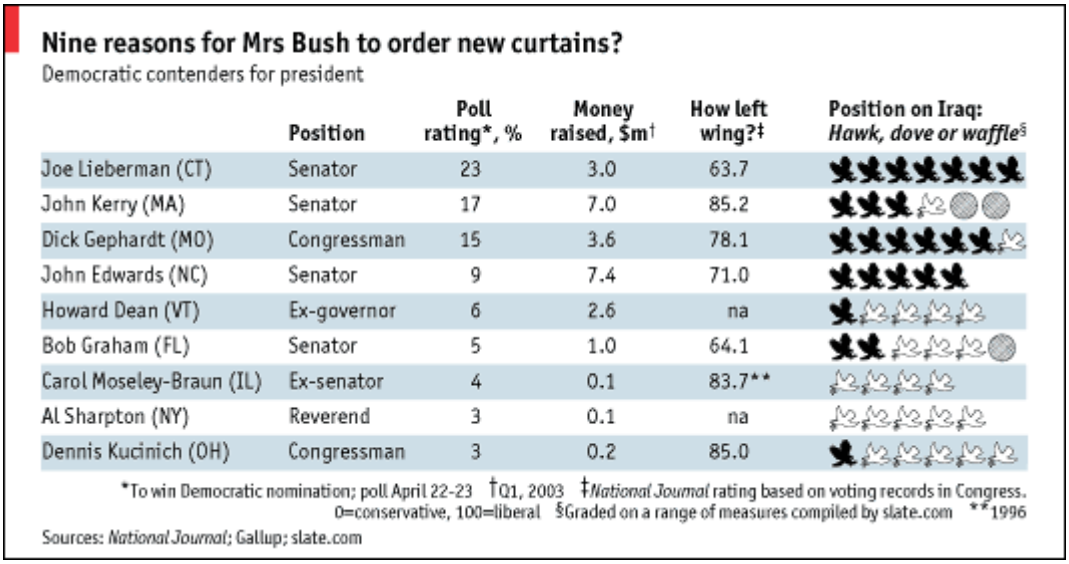
IF A week is a long time in politics, beginning your nominating process a year and a half before polling day seems excessive. Few Democrats even in South Carolina will bother to tune in to the dutiful TV stations that are running the 90-minute gabfest on May 3rd. The ABC affiliate in Washington, DC, has ditched the debate for re-runs of “The Practice” and “ER”.

All the same, this is a significant moment. It comes as George Bush is expected to declare the Iraq war over, and when attention is turning from foreign to domestic policy. This will also be the first time the candidates appear together, and first appearances matter. And, right on cue, comes the first stirring of rancour, debate and even ideas from the contenders.

If you look at Mr Bush's polling numbers, you might decide that the Democrats should just fold their tents and go home: he leads them all by a mile. But if you look at the economy (poor) and at public confidence in Mr Bush's economic management (worse), a Democrat should stand a good chance. As Karl Rove, Mr Bush's political strategist, has repeatedly insisted, the election is likely to be close. The “50:50” nation of the 2000 election has shifted towards the Republicans a little, but not much.

Any presidential campaign sets candidates a series of tasks—raising money, organising a team and so on. This time, though, there is also an initial requirement: nominees need to pass a threshold of credibility on national security. The election will probably not be about foreign policy, but Mr Bush will try to make it about “leadership”, because voters say that is the quality they most admire in him, and that means leadership abroad.

Three candidates clearly pass the tough-on-terror test. Senators Joe Lieberman and John Edwards and Congressman Dick Gephardt have all been hawkish on Iraq (see table). Bob Graham, a Florida senator, probably does too. He voted against the Iraq war resolution, but that was because he wanted America to concentrate on terrorist groups. He also has a distinguished national-security record.



Nine reasons for Mrs Bush to order new curtains?

Democratic contenders for president

	Position	Poll rating*, %	Money raised, $m†	How left wing?‡	Position on Iraq: *Hawk, dove or waffle*§
Joe Lieberman (CT)	Senator	23	3.0	63.7	
John Kerry (MA)	Senator	17	7.0	85.2	
Dick Gephardt (MO)	Congressman	15	3.6	78.1	
John Edwards (NC)	Senator	9	7.4	71.0	
Howard Dean (VT)	Ex-governor	6	2.6	na	
Bob Graham (FL)	Senator	5	1.0	64.1	
Carol Moseley-Braun (IL)	Ex-senator	4	0.1	83.7**	
Al Sharpton (NY)	Reverend	3	0.1	na	
Dennis Kucinich (OH)	Congressman	3	0.2	85.0	

*To win Democratic nomination; poll April 22-23 †Q1, 2003 ‡*National Journal* rating based on voting records in Congress. 0=conservative, 100=liberal §Graded on a range of measures compiled by slate.com **1996

Sources: *National Journal*; Gallup; slate.com

That leaves two interesting cases. Senator John Kerry, a Vietnam veteran, voted for the war resolution but criticised Mr Bush for his diplomatic setbacks. He seemed to equate Mr Bush with Saddam Hussein by talking of “regime change” in Washington. Whether that makes him soft on national security is one of the questions for the campaign.

Howard Dean, a former governor of Vermont and the leading domestic critic of the war, would certainly fail the national-security test in a general election. But in the primaries candidates compete for the votes of activists, and his stance is winning him applause from the faithful in states with early contests. His quixotic candidacy is now posing a tough question to his rivals. Do they need to move to the left, as often happens in primaries? Or should they burnish their national-security credentials by attacking his anti-war stance, as Mr Kerry did this week?

Primary campaigns are endurance tests, toughening up candidates for the marathon to come. Before the first proper vote, in Iowa next January, comes the “invisible primary”, which tests four skills.

•**Ideas.** It may seem surprising, but these matter. They help challengers formulate a compelling reason why voters should change presidents.

Here Mr Gephardt has jumped ahead. Last week, he unveiled a proposal to expand medical insurance to almost all uninsured Americans. He would do this by requiring all companies to provide workers with health insurance. He would double a federal tax credit to help the firms pay 60% of the premiums. Administratively, this would be simpler than Bill Clinton's ill-fated attempt to expand medical coverage. But because all companies get the bigger tax credit, including those that already help pay medical costs, it would be expensive. Mr Gephardt says he would pay the cost—$210 billion a year, he claims—by scrapping Mr Bush's future tax cuts.

The economics of the proposal may be debatable (why subsidise companies that already provide insurance anyway?). But, politically, it is bold. It defines Mr Gephardt as more than just the man who has failed to win back the House of Representatives in the past three elections. And it could change the terms of the tax debate from “Are you for or against tax cuts?” to “Do you want lower taxes or more health care?” His rivals now have to come up with their own ideas. The drawback, though, is that big health-care plans are hard to sell—as Bill Bradley discovered in 2000.

•**Money.** In many ways, this is what the invisible primary is about. Here, too, there are surprises. In the first quarter of the year, Mr Edwards scooped up the most cash, nudging out Mr Kerry, whose money-machine was thought to hum most smoothly (see table). This gave Mr Edwards's campaign a shot in the arm after some feeble TV performances and poor poll ratings. Mr Dean also raised much more than expected.

But the cash is not everything. Messrs Kerry and Dean point to their broader base. They both mustered more donors than Mr Edwards, who raised much of his cash from rich trial lawyers (he was one before his election in 1998). Other campaigns suggest that he will not be able to go to that well too often. Perhaps. But money begets money, and Mr Edwards should be able to buy himself time for the next task.

•**Organisation**. The ability to build up grass-roots support and assemble teams of specialists, from

policy advisers to buyers of advertising, is not only crucial for future campaigning; it is a measure of the national party's confidence.

Organisation has been Mr Kerry's strength. He won the “Bob Shrum primary”—the contest to hire a well-known consultant who advised Al Gore. In contrast, the Edwards campaign has suffered one or two embarrassing losses (including Mr Shrum). The danger for Mr Kerry is that he seems to be building the sort of all-things-to-all-men campaign that can defend his presumed front-runner status from attacks of either left or right. As the Gore campaign proved, good consultants are no substitute for a good message.

•**Endorsements**. Mr Kerry has picked up some useful backers, such as Harold Ford Jr, a respected black congressman. But the endorsement that matters is that of the unions. This time, the AFL-CIO intends to wait and see who has the best chance of beating Mr Bush. This is bad news for Mr Gephardt, who might have hoped to pick up their early endorsement.

The bottom line is that all the front-runners can take some satisfaction from the past few weeks, which leaves the field a very crowded one. When weeding-out starts next spring, it will be drastic. Next year's primary calendar is unusually compressed. Between the Iowa caucus on January 19th and March 2nd, more than half the states will hold nominating races. In effect, the race will be a February blur.

No one is sure what effect this compression will have. But several states hold contests on the same day. This should benefit candidates with names known nationwide (like Mr Lieberman) or with the best organisations (Mr Kerry, at the moment). Against that, a candidate able to build momentum could sweep all before him. The jockeying for position starts in South Carolina this weekend.

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America and the Gulf

Ciao, Saudi

May 1st 2003
From The Economist print edition

An unspoken benefit of victory

"FIRST, for over seven years the United States has been occupying the lands of Islam in the holiest of places, the Arabian peninsula, plundering its riches, dictating to its rulers, humiliating its people, terrorising its neighbours"; and so on and so forth. Thus spake Osama bin Laden and his accomplices in their seminal declaration of *jihad* against Jews and Crusaders in 1998. That first gripe should soon be largely assuaged.

The American crusaders will not be leaving the Arabian peninsula entirely, but most of them will depart from Saudi Arabia, the land of Mecca and Medina. So said Donald Rumsfeld, America's defence secretary, during a post-war tour of the Gulf that also took him to Basra and Baghdad. (The task of actually declaring the war over falls to President and Commander-in-Chief Bush.) The American air headquarters has already been shifted from Saudi Arabia to Qatar. Apart from a few troops on a training job, the rest of the Americans, and all their aircraft, will follow soon.

EPA

So long. We'll call you

America has had a military presence in Saudi Arabia for 50 years, but it ballooned to 500,000 when Iraq invaded Kuwait. After the ensuing war, around 5,000 Americans stayed on, mainly to enforce the "no-fly zone" over southern Iraq. Before and during the recent fight, that figure roughly doubled. Now, as Mr Rumsfeld says, Saddam Hussein no longer represents a threat to Saudi Arabia, and the no-fly zone is no more. America is also winding down its operations in Turkey, the base for patrols over the northern zone.

This rejigging of the American "footprint" in the Gulf is likely to form part of a wholesale review of its global military disposition. Before September 11th, when nation-building was still a dirty term among Republicans, the Bush administration aspired to a humbler presence around the world. A couple of wars later, it may now be able to revise its commitments in Asia and in Europe (where it may move some troops to the more compliant, cheaper and strategically handier "new" side of the continent), as well as in the Gulf.

But, although America cannot say so, al-Qaeda is also part of the reason why the Saudi shoe no longer fits. Folklore has it that in 1990 Mr bin Laden offered his *mujahideen* to defend Saudi Arabia from Mr Hussein, to avoid the influx of American servicemen (and—worse—women) which occurred. Islamist terrorists protested against this indignity in several attacks in Saudi Arabia during the 1990s. Since September 11th, the costs of America's ongoing presence have seemed to outweigh the benefits. Victory in Iraq means that America can now leave on a high, rather than in apparent flight. Qatar is a better HQ; and their going may show that Americans are not, after all, appropriative imperialists.

There is a pay-off for the Saudis, too. Popular dislike of the war obliged the country's rulers to be less helpful than America would have liked—though the true extent of Saudi co-operation, like that of other Arab countries, remains murky. The American pull-out will ease the pressure on the ruling family, and (if it really wants to) let it make political reforms without looking like an American stooge.

Yet there may be also a threat to the Saudis. Since September 11th, the kingdom's less savoury aspects, such as its role in financing Islamic extremism, have tested American patience. The idea of cutting the

country adrift has hitherto looked riskier than sticking with it. But Mr Hussein's demise changes that calculation. This week, when Mr Rumsfeld insisted that the two countries are still best friends, he was uncharacteristically diplomatic. If nothing else scares the Saudis, that should.

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Georgia's state flag

Phew

May 1st 2003 | ATLANTA
From The Economist print edition

Another new flag—and a rough baptism for the new governor

GEORGIA's state capitol is built mostly of handsome marble—except for the dreary, dimly lit basement which houses a small exhibition of historic flags flown by the state's regiments. Several of the flags boast the controversial blue-on-scarlet Confederate battle cross. Now it seems that Georgia may at last get a state flag that does not include that particular symbol.

AP

Another year, another flag

On April 25th, the state legislature finally approved an official state flag without the cross. This decision came only after two six-hour-long debates and one mass walk-out. And it is still subject to a referendum next year.

Most Georgians do not get particularly exercised about the state flag, any more than they do about the state bird (the brown thrasher). But, for many rural whites, the Confederate cross is a symbol of their “heritage”. Hence the bumper-stickers with slogans such as “If I had known this, I would have picked my own damn cotton.”

On the other side of the argument, many blacks see the battle cross as a symbol of enduring racism. This is not that surprising, since the symbol was deliberately added to the flag by conservative whites in 1956 as a protest against desegregation. Blacks, whose power within the southern Democratic Party has increased dramatically since those days, have been trying to get rid of the battle cross for years.

In 1999 the National Association for the Advancement of Coloured People began threatening to boycott states still flying the Confederate flag. Since then South Carolina has taken its flag down, though Mississippi has voted to keep its own flying. In 2001 Roy Barnes, Georgia's Democratic governor, persuaded the legislature to pass a new flag with a much shrunken battle cross. That decision may have cost him his governorship: last November, rural whites voted in Sonny Perdue, a little-known Republican state senator, who promised a statewide referendum on the flag.

In January, Mr Perdue duly suggested a pair of yes-or-no votes for March 2nd 2004, the day of Georgia's presidential primary. The first would decide whether to keep the 2001 flag; the second would decide whether to replace it with the 1956 flag or its predecessor (itself based on the Confederate “stars and

bars”). But that only prompted the Democratic legislature to come up with alternative flag designs and referendums of its own.

The resulting soap opera included walk-outs and arguments about the correct size of a state flag. In a fairly typical exchange, one Democratic state senator thundered that “the governor has made a deal with the devil”, only for a Republican to retort that the deal was actually with “a loving Jesus Christ”. The flag issue also got entwined with the state budget, where Mr Perdue had to deal with a $620m deficit in the upcoming financial year.

On April 25th, the last day of Georgia's longest legislative session since 1889, black Democrats managed to persuade Mr Perdue and the Republicans to accept a compromise. Georgia would adopt a new official state flag, shorn of the battle cross but with a resemblance to the Confederate stars and bars (see picture). And there would be a referendum giving voters a choice between this flag and the 2001 version. The Democrats also helped Mr Perdue pass his $16 billion budget, by agreeing to a $180m rise in tobacco taxes.

In theory, this should have pleased most people. A recent poll showed that most Georgians want a referendum, and everybody wanted to pass the budget. Yet the six Republican state assemblymen and the 11 state senators who agreed to limit the popular vote to the 2001 and 2003 flags are taking a battering for not including the battle cross.

The man who may have suffered most, though, is Mr Perdue. The diehard white “flaggots” are furious that they will not be able to vote on the 1956 flag. The state legislature is still grumpy that he reintroduced this poisonous issue all over again. Although it agreed on a budget, it pointedly failed even to discuss an ethics bill he had championed. Georgia's first Republican governor since 1872 is in for a rough ride, whichever flag the voters choose.

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An earlier foreign war

They fought Franco, in Abe's name

May 1st 2003 | NEW YORK
From The Economist print edition

The last survivors of a different American intervention

AS THE first American soldiers began to come home from Iraq, a tiny group of veterans of another, long-ago military intervention met in New York on April 27th. The volunteers of the Abraham Lincoln Brigade embarked for Spain two-thirds of a century ago to fight against Francisco Franco and his version of the fascism of the 1930s. Of the 2,800 who served with the brigade, 800 died in action. Only 90 are still alive. The 17 who made it to their 67th reunion recollected battles called Brunete, Jarama, Teruel and the Aragon offensive.

They got no help from the American government. Like the governments of Britain and France, Franklin Roosevelt's administration preferred to stay on the sidelines of a civil war in which Nazi Germany backed Franco and communist Russia helped his Republican opponents. To reach the front, the Abraham Lincoln volunteers—most of them communists—had to get on a boat to France and then trudge across the Pyrenees after France had closed its border with Spain to would-be fighters.

Those at the reunion had not changed their minds. Richard Dreyfuss, a relatively youthful guest speaker, declared that no label is nobler than “premature anti-fascist”. There were songs of protest in several languages, including a rendition of the communist “Internationale” that brought many of the audience to their feet with fists raised. Clarence Kailin was unemployed when he left Wisconsin for Spain in February 1937, eager to help defeat fascism. “It wasn't the phoney kind of fight for democracy that Bush talks about,” says Mr Kailin, who served with the brigade for nearly two years before a machinegun bullet shattered his right elbow.

Black and white Americans fought side by side in Spain, a mingling of the races it took years for the American army to imitate. Some of the blacks who, after distinguishing themselves in Spain, went on (like many of the brigade's survivors) to serve in the second world war found themselves in black-only units—or working in the kitchens.

Unlike the men and women who fought in Iraq, the fighters in Spain got a faint welcome when they returned home. In 1938, New York City's policemen stopped veterans who wanted to lay a wreath for their fallen comrades. Even so, in the second world war several battle-hardened Abraham Lincoln men worked in the OSS, the precursor of the CIA. In 1996, Spain gave its citizenship to all the brigade's survivors.

The Spanish Republicans' battle-cry—*No pasaran!*, “They shall not pass!”—has a new application for the modern left: the war against globalisation. Abe Osheroff helped to plan the 1999 demonstrations in Seattle. Speaking at an earlier reunion, in 2001, another veteran, Moe Fishman, tried several times to say “globalisation”, but stumbled. “It was so much easier to say when we called it imperialism,” he explained.

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Dealing with the foot-draggers

Blame, aim, fire

May 1st 2003 | WASHINGTON, DC
From The Economist print edition

Off the hook: Turkey, Germany, Russia. But not France

Get article background

RECONSTRUCTION is something that not just Iraq needs. George Bush's advisers are still warily surveying the damage the row about the Iraq war has done to America's relations with some of its ex-friends.

France, self-appointed opposer-in-chief of America's decision to go to war, is already on notice that there will be consequences for its blocking actions at the UN. Germany and Russia, which supported France, seem to have dropped out of the administration's direct line of fire. So has hapless Turkey, which refused to let America use its bases for sending troops into Iraq. It lost influence and aid as a result and, officials feel, has already been punished pretty effectively. Now the challenge is to bring the UN and NATO into a helpful alignment with American goals.

AP

Will that leave a stain?

Most of the Bush people accept that at some point there needs to be a UN Security Council stamp of approval for the new Iraq—not just to speed humanitarian help, but also eventually to approve a new constitutional set-up. Without one, the whole post-war venture, including future oil contracts, could get snarled in endless legal wrangles. But how best to go about this: one big sanctions-busting resolution (as Mr Bush would prefer), or several smaller ones, as and when needed?

The choice depends, as one senior administration official puts it, on whether the French intend to “torture us some more”. Despite President Jacques Chirac's recent assurance to Mr Bush that he is ready to work with him “pragmatically” on Iraq, no one knows quite what to expect from France these days. And America does not want to be drawn into a showdown over the peace that could be as bruising as the one that preceded the war.

The signs are not good. Despite recent conciliatory-sounding noises from the refuseniks, Russia's Vladimir Putin insisted to Britain's Tony Blair this week that the sanctions cannot be lifted until the fate of Iraq's weapons of mass destruction—indeed, their very existence—has been clarified. The Bush people are unhappy that both Russia and France have been using the sanctions-lifting issue to insist on closer

UN involvement in Iraq, including in the hunt for banned weapons.

As for NATO, it sustained a damaging “hit above the waterline” during the Iraq row, according to its secretary-general, Lord Robertson. This week France, Germany, Belgium and Luxembourg (all opponents of the war) agreed to set up a new headquarters for Europe-only military tasks, where neither NATO nor its equipment is involved. Despite German efforts to tone down its content, the initiative is viewed by senior American and British officials as deliberately divisive. Colin Powell, America's secretary of state, noted that it was not more headquarters that Europe needed, but more clout.

More hawkish members of the administration are much more critical. For them, the summit revived memories of that earlier NATO battle, in February, when France, Germany and Belgium for a time blocked the sending of defensive equipment to Turkey. That row was resolved only when Germany helped take the issue away from the alliance's chief political body, the North Atlantic Council, to its Defence Planning Committee—where France, outside the NATO military structure since de Gaulle left it in 1966, chooses not to sit. This could happen with future issues, too.

America's patience with France's foot-dragging in the alliance, never great, is now just about exhausted. Mr Bush seems convinced that the French are deliberately trying to pull Europe and America apart. That, in turn, increases his tendency to rely on coalitions of the willing (which is what Mr Chirac protests about most). “If France wants to destroy the transatlantic alliance,” says a senior Bush person, “then it shouldn't complain if we act unilaterally.”

So far, reprisals have been largely verbal. Mr Bush recently noted that Mr Chirac was unlikely to get an early invitation to his Crawford ranch. Congress amused itself by changing French Fries to Freedom ones, and Laura Bush snubbed the opening gala of a show celebrating the 200th anniversary of the Louisiana Purchase, a symbol of ancient Franco-American co-operation. More practical score-settling now seems likely—if not as dramatic as the hawks are demanding.

Most of France's trade with America is protected by international rules. But administration officials are keen to ensure that France (and Russia, too) do not benefit unduly from past connections with Saddam Hussein's regime. There is bound to be close scrutiny of oil deals struck when the Iraqi dictator was handing them out on political merit rather than for proper tender. Military ties and defence contracts will also suffer (which in one way is unfair, as France's military men disagreed with Mr Chirac's Iraq policy, and would have been keen to join America in the fight).

Presidents Bush and Chirac are bound to meet early next month at Evian, where France is hosting a G8 summit. Germany's Gerhard Schröder and Russia's Mr Putin will be there, too. But it is the body language between Mr Bush and his host that will be most closely watched. This week the White House had to quash reports that Mr Bush was reluctant to spend even the night of the summit on French soil.

Reasons for hope

If relations are to be mended, the trick will be to look to the future. Senior administration officials point out that on some issues—counter-terrorism, North Korea, instability in Africa—co-operation with France has remained excellent throughout. America's much delayed publication of the Middle East road map will be welcomed by France. Meanwhile, past French objections to NATO taking over the security force in Afghanistan have suddenly melted away. There is even the hope of a NATO follow-on force to help maintain stability in Iraq.

The American-led coalition of the willing that went into Iraq, admits one State Department official, was as odd as the French-led coalition at the UN that opposed it. The Atlantic alliance, to which everybody on both sides belongs (even Russia, indirectly, through the NATO-Russia Council), is still the fundamental link between Europe and America, and no one is for giving it up. That is a start.

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Dealing with Cuba

Crackdown time. But whose?

May 1st 2003 | MIAMI
From The Economist print edition

Fidel Castro has got rougher, so what does George Bush do?

WELL before it took office, the Bush administration promised tough action on Cuba. Most administrations do. So far this White House, too, has in practice done little. That may be about to change.

In his harshest crackdown on dissent in almost four decades, Fidel Castro's government last month jailed 78 of its critics for “conspiring with American diplomats”; they got sentences of up to 28 years apiece. Then three hijackers who tried to divert a ferry to Florida were executed. All this produced international cries of protest. The pope called for clemency. Left-wing intellectuals better known for criticising American foreign policy joined in, from Susan Sontag to the Spanish film director Pedro Almodóvar. Even Gabriel García Márquez, one of Mr Castro's closest foreign friends, condemned the executions.

Naturally, hardliners among the Cuban exiles living in America, most of whom voted for Mr Bush in the 2000 presidential election, think that, after taking down a dictator in Iraq, the administration should turn its attention to another closer to home. They may get an answer, of some sort, on May 20th, Cuban independence day. Mr Bush has used this anniversary two years in a row to say that he wants to see “a peaceful transition to democracy” in Cuba. The trouble is, says Philip Peters, of the Lexington Institute, a Washington-based think-tank that favours lifting economic sanctions against Cuba, “there are not a lot of options, at least none that would satisfy his closest political allies.”

The hardliners want two things: a suspension of the increasingly popular charter flights between the United States and Cuba, and a ban on cash remittances sent by exiles to their relatives back home. The latter are estimated to be worth as much as $800m a year; ending them would hit the island's fragile economy hard.

The critics say this would be counter-productive, turning attention away from Mr Castro's human-rights abuses to an American president stopping family charity. Anyway, Cuban exiles have long found ways to circumvent restrictions, for instance by sending money by courier through third countries. And a tightening of economic sanctions might well displease Cuba's dissident movement—including those in jail—who in varying degrees oppose the American embargo.

In some ways, Castro's crackdown has eased things for the White House. It has hurt the efforts being made in Congress to lift the embargo. It has also sent a chill through the American business community, which had been showing increased interest in trade with Cuba. The most important effect, however, may be the reaction of the new moderates among the Miami exiles. In a break with hardliners, the influential Cuban-American National Foundation has come out against retaliatory measures. “Castro is counting on the United States to over-react,” says Joe Garcia, the foundation's executive director. With rising dissent and a worsening economy, Mr Garcia believes, Cuba's leader is trying to push the blame on to others.

The moderates in Miami are paying much more respect now to the dissidents inside Cuba, once dismissed as tools of Castro window-dressing. Many exiles were captivated earlier this year when Oswaldo Paya, one of the main dissidents in Cuba, came to Miami. He won the European Parliament's Sakharov Prize last year, and has been nominated for this year's Nobel Peace Prize. In a recent opinion poll, commissioned by the Miami-based Cuba Study Group, 69% of Cuban-Americans said that dissidents on the island were more important than exile leaders to the hope of bringing about democratic change in Cuba. Only 11% felt the exiles played a bigger role.

The hardliners reject the polls, seeing them as part of a “conspiracy to keep Castro in power”. They claim to have Mr Bush's ear. But the moderates are pressing their case, likening those charter flights, and the money sent to relatives in Cuba, to the Trojan horse. Much of their help to the island's growing dissident

movement, in both cash and other things, is smuggled in on flights to Cuba.

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Lexington

Steamroller Ashcroft

May 1st 2003
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Conservatives beware: an out-of-control attorney-general is trampling on your principles

SO FAR, the debate about John Ashcroft has focused mainly on the war against terrorism. Libertarians moan that the hyperactive attorney-general has hugely expanded the government's power to monitor citizens (by wiretapping their telephones and so on); that he has made it much easier to detain and deport immigrants and foreign visitors, particularly Arabs; and that he has ruthlessly accumulated power over the country's sprawling judicial system in his own hands. Conservatives wearily retort that wars force everybody to rethink the balance between freedom and security. Surely the attorney-general is duty-bound to err on the side of vigilance to thwart another September 11th?

Well, yes. But what if you examine Mr Ashcroft's record in other areas, such as medical marijuana, assisted suicide and the death penalty? You find precisely the same pattern of John-knows-best centralisation. The country's terror-fighter has also become the country's self-appointed moraliser-in-chief. And he is trampling all over two conservative principles he used to espouse: limited government and localism.

Begin with an idea precious to most Republicans: states' rights. Mr Ashcroft has prosecuted “medical marijuana” users in California despite a state initiative legalising the practice. He has tried numerous ploys to challenge Oregon's assisted-suicide law (including encouraging the Drug Enforcement Administration to revoke the licences of participating doctors), thus snubbing both the state, which has passed the law not once but twice, and the Supreme Court, which has explicitly left policymaking in this area to the states. He has repeatedly tried to bully local federal prosecutors into seeking the death penalty, despite a long tradition of local discretion in death-penalty cases.

Mr Ashcroft's new reverence for central government is beginning to seem downright Democratic, if not Gallic. The whole point of the American political system is its sensitivity to local differences. Federalism, as Justice Louis Brandeis put it, means “that a single courageous state may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country.” It also means that a huge country with a richly diverse population can try lots of different approaches to moral issues. People in rural Nebraska can adopt a different approach to lap-dancing from people in San Francisco; Vermont can demonstrate its uniqueness by favouring both gay marriage and tight controls on internet porn.

“Moral federalism” has deep roots in America. The English Parliament's Act of Toleration (1689) left religious issues almost entirely to local discretion. People with different religious views congregated in different regions—Puritans in Boston, Catholics in Maryland and so on. The Founding Fathers laboured mightily to keep the federal government out of dictating civic virtue. James Madison noted (in Federalist Paper 56) that different groups progress at different speeds. Alexander Hamilton (in Federalist 17) argued that any attempt to impose a centralised morality would be “as troublesome as it would be nugatory”. The local administration of justice is “the most powerful, most universal and most attractive source of popular obedience and attachment”.

This tradition of moral federalism would seem particularly practical now. The country is still basically split down the middle politically, and this political divide reflects a deeper division about values. When it comes to matters such as God and sex, many of the people who voted for George Bush live in a different moral universe from Al Gore's supporters.

There are clearly some areas where the federal government has to step in to protect individual rights. It was right to use its might to dismantle segregation in the South. Mr Ashcroft has legal grounds to argue that the constitution guarantees individual citizens the right to bear arms. But in general the Justice Department needs to err on the side of caution on issues where reasonable people can disagree. It should recognise that different communities have very different views: large cities, for instance, voted for Mr Gore by a 71% to 26% margin, while small towns and rural areas voted for Mr Bush by 59% to 38%. And it should try, as far as possible, to allow those communities to make decisions for themselves, rather than forcing them to bow the knee to Washington. Agreeing to disagree offers the country the best chance of avoiding an endless culture war in which both sides use the federal government to enforce their views.

Nobody should be more worried about Mr Ashcroft than conservatives. Hasn't it usually been the Democratic Party that has championed big government and Washington-knows-best morality? And hasn't it usually been the Republican Party that has stood for local variety? In the 1990s the Republicans owed many of their biggest successes—from welfare reform to school vouchers—to their enthusiasm for federalism. Mr Bush owes his job partly to the quintessentially federalist Electoral College.

A mistake by any measure

Mr Ashcroft's conversion into a centraliser is both hypocritical and short-sighted. It is hypocritical because Mr Ashcroft was once a leading critic of big government. As attorney-general and then senator for Missouri, he resisted a federal injunction to desegregate St Louis's schools so vigorously that the *Southern Partisan*, a neo-Confederate magazine, singled him out for praise.

It is short-sighted because, as an evangelical who refrains from smoking, drinking, dancing and looking at nude statues, Mr Ashcroft represents a minority in his own party, let alone the country. He has no chance of winning the culture wars: the forces arrayed against him, from the media to the universities, are too vast. The best he can hope for is a live-and-let-live attitude that gives minority views like his own room to flourish. Mr Ashcroft will come to rue his Faustian bargain with the federal government the next time a Democrat sits in his office.

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Argentina's presidential election

Adiós Menem, hallo Kirchner?

May 1st 2003 | BUENOS AIRES
From The Economist print edition

Of two Peronists, the younger and more social-democratic looks better placed to win a run-off ballot this month

Get article background

HE TRIED hard to put a brave face on it. But Carlos Menem's expression and the mood of his entourage darkened as the results came in from last Sunday's presidential election. During the campaign, Mr Menem, Argentina's Peronist president from 1989 to 1999, had repeatedly boasted that he would win outright. Long after the polls had closed, he still maintained that he would triumph by “eight or ten points”. So, rather than victory, Mr Menem's 24% of the vote and narrow lead over Néstor Kirchner (22%), whom he must now face in a run-off ballot on May 18th, looked like a shattering blow to the former president's carefully cultivated aura of invincibility—and to his hopes of a comeback.

Mr Kirchner, the previously obscure governor of a sparsely populated Patagonian province and also a Peronist, ran a bland campaign. But he looks set to be the chief beneficiary of Argentina's newly fractured politics. Mr Menem, a wily and unscrupulous political fighter who spent six months under house arrest on arms-trafficking charges in 2001, still claims proudly never to have lost an election. He cannot be written off quite yet. But, aged 72, he now looks old and tired.

The election said much about the mood of a country that has gone through an economic Calvary since the last presidential poll in 1999, leaving 58.5% of Argentines in poverty. First, despite widespread disillusion with politicians, Argentines showed their commitment to democracy: at 78%, the turnout was only slightly below that for past presidential contests. Less than 3% cast blank or spoiled ballots, compared with almost a quarter in a congressional election in 2001.

Second, the Peronists retain a powerful grip on Argentina's politics, despite having failed for the first time to unite behind a single candidate. That failure owed everything to the bitter feud between Mr Menem and Eduardo Duhalde, Argentina's incumbent president. The election gave Mr Duhalde, who was backing Mr Kirchner, cause for satisfaction. Almost half of Mr Kirchner's votes came from the sprawling province of Buenos Aires, suggesting that Mr Duhalde's longstanding political machine there is still well oiled.

Third, there are some tentative signs of political renewal. The Radical party, the non-Peronist pole of a two-party system since 1945, has all but disappeared: its official candidate won just 2% of the vote. But

two Radicals-turned-independents did well, and can hope to build new opposition parties. Ricardo López Murphy, a liberal former economy minister, won 16.3%. Elisa Carrió, a leftish anti-corruption campaigner, gained 14.2%, despite little money.

The run-off will be a very different affair from last Sunday's election, one that will be much more difficult for Mr Menem to fight. He has invoked the memory of better days under his rule, arguing that only he can restore Argentina to economic growth. That works with his hardcore supporters. But most Argentines remember the stink of corruption surrounding his regime, and blame him for laying the ground for subsequent economic catastrophe: polls show at least 50% say they would never vote for him.

Mr Kirchner excites less love—but less hate. His trump card was to announce that he would retain Roberto Lavagna, Mr Duhalde's economy minister, who last year hauled the economy back from the brink of hyperinflation. He has already received a back-handed endorsement from Ms Carrió: “I am not going to back Menem, and I believe in voting,” she said. Mr López's supporters may split fairly evenly. Adolfo Rodríguez Saá, another Peronist, who came fifth with 14%, was seeking a deal.

In policy terms, the run-off is a battle between Mr Menem's glitzy conservatism and Mr Kirchner's nebulous social democracy. Mr Menem says he would pay Argentina's debt in full (though stretching out its term). He wants a strong peso, would put the army on the streets to fight crime and, in foreign policy, would return Argentina to automatic alignment with the United States. Mr Kirchner would try to take a tougher line in negotiations with foreign creditors and the IMF, would be mildly interventionist in economic matters, and wants to revive the Mercosur trade pact with Brazil.

Whoever wins faces a daunting policy agenda, centred on restoring Argentina's international credit, turning a cash-driven incipient economic recovery into sustained growth, and maintaining responsible fiscal policies while also trying to help the poor. Governing may well be hard. Divided as they are, the Peronists will not necessarily unite behind the next government. Mr Kirchner was the least popular of the three Peronist candidates among the party faithful; around half his votes came from non-Peronists. With him in office, real power might lie, awkwardly, with Mr Duhalde. But Mr Menem would attract outright opposition from Mr Duhalde, and from half the country.

On the other hand, the new president will have a popular mandate. That is something Mr Duhalde lacked: he was chosen by Congress in January 2002, after Fernando de la Rua, a hapless Radical, resigned during riots. Mr Duhalde says he will ask Congress for a pledge not to block laws proposed by the next president during his first six months in office. So he, at least, is confident that his successor will not be Mr Menem.

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Colombia and its neighbours

Ripples of instability

May 1st 2003 | BOGOTÁ AND CARACAS
From The Economist print edition

Tensions from guerrillas and drugs

FOR years, it has been claimed that Colombia's conflicts are spilling over its borders, threatening the stability of its neighbours. But hitherto there has been little evidence of this—outside immediate frontier areas. These have seen a few refugees, and periodic incursions by leftist guerrillas from the FARC or ELN or rightist paramilitaries from the United Self-Defence Forces of Colombia (AUC), seeking either plunder or rest and recreation. Is the Colombian conflict now starting to cause wider ripples in South America?

There are three reasons for thinking so. One is that Plan Colombia, the American-backed scheme to fight guerrillas by fighting the drug production from which they derive income, is having an effect: coca cultivation is falling in Colombia, but rising elsewhere. Second, Álvaro Uribe, who took office as Colombia's president last year, has been seeking—but not always getting—wider co-operation from around the region. Staunchly pro-American, he has echoed George Bush in demanding that his neighbours be either with him or against him in curbing “terrorists”, as he has dubbed all three of Colombia's irregular armies. Third, tension has become acute between Colombia and Venezuela.

Colombia's government is furious that Hugo Chávez, Venezuela's populist president, has failed to co-operate in policing the border region. In Colombia there are frequent rumours that FARC commanders fled to Venezuela after peace talks failed last year. In March, Colombian peasants claimed that Venezuelan air force planes crossed the border on a bombing raid to help a FARC column fighting paramilitary opponents. These claims are denied in Caracas but given some credence by Colombia. They sparked another round in a long-running war of words.

Venezuela denies Colombian charges of laxity towards the guerrillas. José Vicente Rangel, its vice-president, in turn accused Mr Uribe's government of complicity with the AUC. His comments provoked a sharp diplomatic note from Colombia.

The border tensions come on top of worries about the impact of Venezuela's political conflict and exchange controls on what was once a thriving trade between the two countries. Colombia's exports to its neighbour were down more than 70% in January, compared with the same month last year.

Last month, Mr Uribe and Mr Chávez met in Puerto Ordaz to try to find diplomatic solutions to their many differences. Mr Chávez promised to release $300m to allow Venezuelan importers to repay their Colombian creditors. And Venezuela finally signed an agreement on the treatment of Colombian refugees that Colombia had long wanted. On border security, Mr Chávez repeated his habitual promise of co-operation. But the Venezuelan president still refuses to revive mechanisms for formal military collaboration or to contemplate intelligence-sharing, though he did agree to more frequent meetings with Mr Uribe.

Further incidents seem inevitable. Along the border, cattle ranchers, Indians and local priests all say that the Venezuelan armed forces do not patrol. “I've been three times to the army to complain of guerrilla presence near our communities,” says an Indian *cacique* (community leader) in Zulia province. “I've

grown tired of complaining—they never do anything." Now, the paramilitaries have followed the guerrillas over the border, and are offering their services to Venezuelan ranchers. Publicly, the ranchers say they want nothing to do with this; they want their own army to push the guerrillas back into Colombia. But with land disputes proliferating inside Venezuela, that could change.

For years, Colombia's guerrillas have seen neighbouring countries as handy refuges. Now, there are a few hints of deeper connections, intertwined with drugs. Last month Bolivian police arrested a Colombian who they claimed had links both to his country's guerrillas and to local coca farmers; he was alleged to be involved in setting up a Bolivian guerrilla group. In Peru, coca growers have become more radical, though that almost certainly owes more to American pressure than to the FARC. Brazil's leading drug supplier, arrested two years ago, had FARC protection.

All of this should worry other governments, says Mr Uribe. He has launched an aggressive round of regional diplomacy. Peru, which has recent experience of terrorism, is sympathetic. So is Panama. But like Venezuela, Brazil is unenthusiastic about American involvement in Colombia and is reluctant to brand the guerrillas as terrorists. A trip by Mr Uribe to Brasília last month produced only an offer by Brazil to study whether it might pass on intelligence from Sivam, its new high-tech Amazonian surveillance system. A meeting in Bogotá of regional foreign ministers and defence chiefs earlier this year ended only with a vague pledge to co-operate more closely. Watch this (unpatrolled) space.

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Paraguay's election

The new boss

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Another five years for the Colorados

THE economy has been in recession for five out of the past six years. The outgoing president, found to possess a stolen BMW, only narrowly survived impeachment for corruption. After 56 years in power—most of them during the long dictatorship of General Alfredo Stroessner—the Colorado Party might have expected to be punished by the voters. But that is not the Paraguayan way. Nicanor Duarte Frutos, the Colorado candidate, won the presidential election on April 27th. In doing so, he maintained the Colorados' record as the world's longest-serving ruling party.

For that, the Colorados can thank their powerful political machine, which in General Stroessner's day all but fused with the government; most civil servants still belong to the party. Yet since Paraguay became a democracy in 1989, the Colorados' grip has started to weaken. According to preliminary results, Mr Duarte won only 38% of the vote (at the last election, in 1998, the Colorados got 54%). It helped him that independent candidates took votes from the Liberals, the traditional opposition. The Liberal candidate won 23%, barely more than Pedro Fadul, a fervently Christian businessman, with 22%. Fourth with 13% was Guillermo Sánchez, a front man for Lino Oviedo, a dissident Colorado and failed coup leader in exile in Brazil. The Colorados seem to have lost their majority in the Senate; they will be forced to seek allies from the opposition's ranks.

Mr Duarte, a former education minister, is from a traditional Colorado family, and joined the party when aged 14. He claims to be a moderniser. He won the nomination in an unusually clean party primary, and promises to crack down on Paraguay's chronic and pervasive corruption. But he comes from the party's traditionalist faction, which remains loyal to the memory of General Stroessner's Paraguayan-style fascism. In the campaign, he repeated in Guaraní, the native language spoken by many ordinary Paraguayans, *"Che tendota, che la jefe"* ("I am the leader, I am the boss").

Rather than backing long overdue reforms of the state, he promised public works. He opposes privatisation of the telephone and electricity companies. He promises cleaner, more efficient administration. But can he deliver it? The Colorados are a questionable lot. Their new senators include Julio Osvaldo Domínguez, who with his father, Osvaldo, owns a tobacco firm, a newspaper and Paraguay's top football club. They have been accused of tax evasion, pirating cigarette brands, and trying to register Brazil's excise stamp as a Paraguayan trademark to ease smuggling. Both deny any wrongdoing. In his campaign, Mr Duarte used a helicopter belonging to Osvaldo Domínguez.

Paraguay's outlook remains bleak. Having shrunk by 4% last year, the economy is unlikely to grow until 2004. Inflation is rising. The government is bankrupt: it borrowed from the central bank before the election to finance a fiscal deficit of 3.8% of GDP, and is $31m in arrears in payments on its foreign debt. Talks with the IMF broke off last year over the government's failure to reform.

Unlike some Paraguayans, Mr Duarte is a fan of Mercosur, the trade block that links his country to Brazil and Argentina. He also wants Paraguay to join the Andean Pact. No doubt he hopes that economic revival elsewhere in South America will help his country. Failing that, even Paraguayan patience may run out. The Colorados could eventually be forced to choose between modernisation and defeat.

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Canada's terrorism trial

A long wait for justice

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Painstaking police work—and intelligence failures

AP

Sikh nationalists in the dock

AS THE years went by, the families of the victims feared that the terrorists who blew up Air India flight 182 on June 23rd 1985 would never be brought to justice. The plane, a Boeing 747, was en route from Toronto to Delhi when it exploded off southern Ireland. All 329 people on board, most of them Canadian Hindus, died. Finally, on April 28th, two Sikh nationalists went on trial in Vancouver for the world's worst act of aerial terrorism before September 11th 2001. Ripudaman Singh Malik, a businessman, and Ajaib Singh Bagri, a millworker, pleaded not guilty to eight charges, including murder, attempted murder and conspiracy.

The bombing was part of a wave of attacks that followed an incident in 1984, when the Indian army stormed the Golden Temple in Amritsar, Sikhism's holiest shrine, to capture an armed band of Sikh separatists. The bomb was in a suitcase loaded in Vancouver. An hour earlier, another suitcase, this one in transit from a Canadian Airlines flight to another Air India flight, had exploded at Narita airport in Tokyo, killing two baggage handlers.

The Royal Canadian Mounted Police thought they had a pretty good idea who was responsible for the bombing from the start. Both the Mounties and the Canadian Security and Intelligence Service (CSIS) had been keeping an eye on Sikh extremists in Canada. But investigators faced formidable obstacles. The evidence lay at the bottom of the Atlantic. It took several dives to recover the aircraft's black box, a third of the bodies and enough other material to show that the plane had been blown up.

Police inquiries among Indian-Canadians were thwarted by fear. Sikh separatists controlled many temples in British Columbia. People who spoke out against extremism were beaten, bombed or killed. An important potential witness was lost when Tara Singh Hayer, a newspaper publisher paralysed by an earlier shooting, was murdered in 1998.

Even so, the prosecution told the court that it would present forensic evidence and 150 witnesses, including two people who would testify that the accused men confessed to being part of the group that carried out the bombing. Defence counsel attacked the credibility and reliability of these witnesses, saying that without their evidence there was no case. Another prosecution witness is the bomb-maker, Inderjit Singh Reyat. On February 10th, he pleaded guilty to manslaughter, claiming he had been told that the bomb would be used to blow up property in India, not an airliner. He was jailed for five years; he had already served ten years for manslaughter for the Narita blast.

All this suggests dogged police work. But some Canadians wonder if the case could not have been solved much earlier, or even averted, if the CSIS had not botched its part. Before the bombings, the intelligence service had the accused men under surveillance, as well as the supposed mastermind, Talwinder Singh Parmar, who died in a shoot-out with police in India in 1992. Three weeks before the Air India bomb, CSIS agents had watched Mr Parmar and Mr Reyat enter some woods and then heard a loud explosion. But the agents did not identify the noise as a bomb, nor treat the incident as important. CSIS agents also managed to erase 286 wiretap audiotapes of telephone calls made by Mr Parmar both before and after the bombing. “Unacceptable negligence,” says the prosecution. Whatever the outcome of the case, which is likely to last well into the autumn, several parliamentarians want an inquiry into the failings of the

intelligence service.

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Japan

The axis of good

May 1st 2003 | TOKYO
From The Economist print edition

AFP

Mr Koizumi is the closest Asia can come right now to a leader like Tony Blair. But is that close enough?

Get article background

IT WAS fitting that Junichiro Koizumi, who was touring European capitals this week, should start by visiting Tony Blair in London. The challenges raised by Iraq and North Korea, the two countries they discussed on April 26th, have revealed just how much Britain's and Japan's prime ministers have in common these days. Each man has loudly echoed George Bush's warnings about weapons of mass destruction and rogue regimes. In doing so, the two men have followed a geographical division of roles. In Iraq, Mr Blair was indispensable in dealing with Saddam Hussein's regime, whereas Mr Koizumi played a supporting role. Now, as attention swings towards North Korea, it is Mr Koizumi's chance to carry the torch.

Mr Blair is clearly a tough act to follow, but comparisons between the two are not hard to make. Like Britain in Europe, Japan is often torn between its alliance with America and its desire to please its neighbours. Since America's presence benefits Asia in many ways, this alliance does not always cause conflict. But Japanese diplomats live in constant fear that a deep rift among Pacific countries might force them to choose, much as the recent transatlantic split has done, temporarily at least, in London and other European capitals.

For a host of reasons—some peculiar to Japan, others reflecting Asian sensitivities and a lack of strong regional bodies—Japan manages this risk less eventfully than Britain does. Its basic foreign policy is to dole out aid and avoid clear stands on tough issues. During the 1991 Gulf war, Japan was irrelevant. Yet by these standards, Mr Koizumi's vocal support for Mr Bush in recent months has been especially bold. America's ambassador in Tokyo, Howard Baker, who reportedly told the secretaries-general of Japan's three ruling parties recently that Messrs Blair, Koizumi and Bush were the world's three great active leaders, was no doubt buttering up his hosts. But given his emphasis on weapons of mass destruction, it was not ridiculous.

Consider: Japan has no seat on the UN Security Council, and so could easily have ducked the Iraq question. Yet even though 70% of Japanese were opposed to the use of force in Iraq, Mr Koizumi spoke out clearly in favour of it. He even telephoned wavering council members to lobby on America's behalf. Mr Koizumi has also supported America's firm line on North Korea since October, when the regime's attempt to enrich uranium for use in nuclear weapons became public.

Most importantly, Mr Koizumi has consistently linked the two cases in principle, on the basis that dangerous regimes cannot be allowed to possess such weapons and that such regimes have to be confronted with a united diplomatic front. Compare that with South Korea's new president, Roh Moo-hyun, who has been much more ambivalent about how to deal with the North.

Still, there is a big difference between sharing America's concerns and actually being able to help deal with them. Can Mr Koizumi really matter as much in the North Korean stand-off as Mr Blair did in sorting out Iraq?

Despite a few basic similarities, Mr Koizumi and Mr Blair are different sorts of leaders, functioning in very different political systems. Perhaps Mr Blair's most valuable contribution on Iraq was persistently and persuasively to make the case for intervention in a debate that the Bush administration often seemed happy to lose. By contrast, Mr Koizumi, though plain-spoken by the standards of Japanese politics, is not the sort of leader to win public debates on a global stage.

That shortcoming might not matter much, however, in a region where governments are inclined to fudge their public statements and let bureaucrats work things out behind the scenes. Given Japan's desire to avoid conflict, and its preference for quiet diplomacy, Mr Koizumi's stance on North Korea's antics has registered as loudly and clearly as Mr Blair's message on Iraq did. Just as Mr Blair's support for America convinced some doubters who were inclined to distrust the Bush administration, Mr Koizumi—the leader of an officially pacifist country—might be able to play a similar role in Asia, even without laying out detailed arguments.

Of course, the North Korean impasse could turn into a long, difficult, diplomatic slog, and fresh tensions may emerge between Mr Koizumi's government and the Bush administration. North Korea's long-running practice of abducting Japanese nationals, which it admitted to during Mr Koizumi's historic visit to Pyongyang last September, could become a sticking-point if talks ever get anywhere. In negotiating with North Korea, Mr Koizumi said in a recent interview, “the past, present and future need to be settled together.”

However relations with America and the region go, Mr Koizumi would be wise to consider another comparison with Mr Blair. At the moment, foreign policy is the one area where Mr Koizumi is taking a clear stand. Meanwhile, he has continued to compromise and stall on domestic economic reforms, and the popularity of his cabinet has been sliding. Some pundits have warned Mr Blair that neglecting domestic issues could be his undoing, however successful he is on the international stage. When Mr Koizumi returns home, he may want to heed that advice.

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About sponsorship

China and SARS

Fever pitch

May 1st 2003 | BEIJING
From The Economist print edition

Reuters

Taking no chances, at last

The government deploys Mao-style methods to contain the disease

Get article background

CHINA's rusting machinery of totalitarian control is being pressed back into service by Beijing's city authorities in a desperate effort to contain the spread of SARS (severe acute respiratory syndrome). Not since the 1980s have so many millions in the capital been subject to such tight controls on their movement and such close surveillance of their private lives. At least it is now in a good cause.

The past few days may have seen some good news in the worldwide effort to contain SARS. The World Heath Organisation (WHO) has rescinded its warning against travel to Toronto and has removed Vietnam from its list of countries with local transmission of the disease (see article). But the news from China remains unremittingly grim. Despite China's sudden decision on April 20th to abandon its efforts to cover up the problem and to sack two senior officials for their handling of the crisis, SARS shows no sign of abating in Beijing. By April 30th, the city had reported 1,440 confirmed SARS cases, 1,408 more suspected cases and 75 deaths from the disease, the worst reported outbreak in the country. The WHO believes that Shanghai may have 30 or so cases, rather than the two officially reported, but that the city is far less affected than the capital.

Since the April 20th volte-face, the Communist Party has launched an anti-SARS campaign that has brought Beijing almost to a halt. Theatres, cinemas and karaoke bars (nightlife for the moneyed classes) have been ordered to close. So too have schools, with parents being urged to keep their children at home. Hotels, office buildings and restaurants are now eerily empty. Even in the rush hour, traffic moves briskly. Not since the days after the suppression of the Tiananmen Square protests in 1989 has Beijing appeared so desolate. The state-run media are subjecting the Chinese, including more than 11,000 who have been quarantined, to a propaganda blitz: endless soldiers singing patriotic songs, tales of heroic party members on the front line of the anti-SARS struggle.

The government's decision to shorten the May Day holiday from seven days to five may achieve its desired effect of deterring people from travelling round the country and spreading the disease. But there are millions in Beijing, mainly university students and migrant labourers, whose homes are outside the capital and who will want to spend the holiday with their families, so the government has decreed that no

student may leave. That may not work, though: the old techniques of controlling people with threats and surveillance have become less effective in a country whose robust economic growth has come to depend on a mobile labour force shorn of ties to the state. Many out-of-towners have headed for home anyway. To keep those left behind in check, neighbourhood committees have been spurred into action. These were once an important tool of social control but in recent years have been reduced to near irrelevance.The committees, which are staffed mainly by Communist Party activists and retired busybodies, have been ordered to monitor the temperature of every resident and report any cases of fever to their superiors. Some foreign residents in diplomatic accommodation have been told to post their temperatures on their doors daily.

Officials admit that residents in Beijing are panicky. There have been riots to the north of the city, directed against a building it was feared will be used to quarantine patients. The city's acting mayor, Wang Qishan, who took over after his boss, Meng Xuenong, was dismissed in the April 20th shake-up, said alarm would abate when people felt they would get effective medical treatment or that the spread of the disease had been blocked. Both remain elusive goals. Henk Bekedam, the WHO's representative in Beijing, says the public health system is overstretched.

In a feat of communist-style mobilisation worthy of Mao's day, the authorities have built a 1,000-bed hospital in a rural area north of the capital to handle SARS patients. According to the official media, some 7,000 workers began the job on April 23rd. Its wards, reportedly equipped with television sets and telephones, were declared ready to receive patients a week later. If only the government had thought of taking health care as seriously before the outbreak began.

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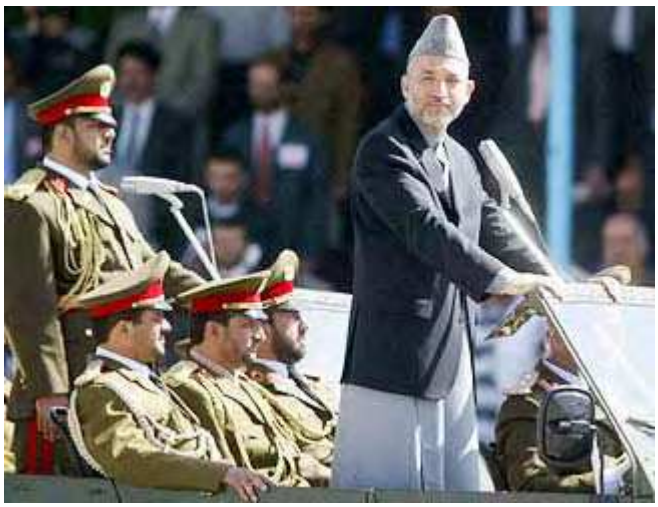
Afghanistan

Hamid Karzai's ragtime infantry

May 1st 2003 | KABUL
From The Economist print edition

AP



Afghanistan's new national army slowly takes shape

Get article background

WITH snow still covering the mountains above Kabul's Eid Gar Mosque, President Hamid Karzai drove round the parade ground in a Russian jeep inspecting soldiers of Afghanistan's new national army for the first time on April 28th. It was National Day, a public holiday marking the fall of the communist regime in Kabul to *mujahideen* forces back in 1991.

The 5,000-odd men on parade included soldiers who had recently graduated from a three-month training period led by American forces. So far seven brigades, including one of special forces, have been trained. The idea is that the army will fill a vacuum brought on by the hoped-for demilitarisation of militia groups.

But not everyone is so sure about the army's ability to meet an increasing security challenge. At the weekend, two American soldiers were killed in Paktia province by a pro-Taliban group thought to number around 800 men, who had perhaps come from border areas in Pakistan; and the number of ambushes and attacks has soared in recent weeks. One Afghan journalist says that, at the current rate of training, it will take ten years to reach the 70,000 men required for a proper army. The new force, he reckons, is little more than Mr Karzai's personal bodyguard.

One problem is that most of Afghanistan's other security forces, including Interior Ministry guards and the police, have not been paid, and are accused of involvement in crime. Up to half of the new army may have already defected, some perhaps rejoining local militia groups.

The relative strength of the militias puts the problem into perspective. For example, the governor of Herat, Ismail Khan, controls most of the west of Afghanistan and has a personal army of around 40,000. With control of customs revenue from trade to both Iran and Turkmenistan, which nets him around $800,000 per day (little of which reaches the central coffers of Kabul), he is able to command loyalty through handsome salaries.

A central part of the solution to all this is meant to be the disarmament, demobilisation and reintegration of the factions, which is being conducted by the G8 industrialised countries under the UN's New Beginnings programme, with a budget of $50m. But already the plan has weaknesses. The disarmament

aspect of it is purely voluntary: around $50 is being offered for each AK-47 handed in—but their market value is around $60.

The demobilisation programme is also being scaled back, and is now likely to apply only to “recognised” militia formations, like the communist-era Afghan army. The private armies of Afghanistan's warlords will not be included, though their members may be eligible for some sort of payoff. Afghanistan's great problem is that no jobs exist for people who leave the warlords' armies. There are 200,000 or so soldiers in these armies, and no sign that their numbers are being reduced.

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About sponsorship

Kazakhstan

Then there were seven

May 1st 2003 | ALMATY
From The Economist print edition

A new law cuts the number of parties

Get article background

THE government of Kazakhstan divides political parties into those that are “constructive”—that is, pro-government—and those that are “radical”. Only seven out of 19 parties have passed muster for re-registration, a procedure just concluded by the justice ministry. Among the successful are Otan, considered to be the party of President Nursultan Nazarbaev; the Communist Party, which ran the country in Soviet times; and, perhaps most surprisingly, Ak Zhol, a reformist group.

Eight parties did not bother to apply for re-registration, a new requirement said by the government “to improve the political system”. A controversial law passed in July last year required all parties to re-register within the following six months and raised the minimum membership needed from 3,000 to 50,000.

It was expected that only three pro-presidential parties would survive, but they proved to be poorly organised. The opposition party Ak Zhol (Bright Road) was first to collect more than 50,000 signatures and to hand in its registration documents. To dilute the potentially strong impact of Ak Zhol on the political scene, the authorities grudgingly decided to admit a few more parties than expected, that is, those judged to be only marginally critical.

The government also seems sensitive to the criticism it has attracted, not only over the new law but by its pressure on the independent media. A leading journalist and two opposition politicians were sentenced to several years in jail last year. Such acts have done more harm to Kazakhstan's reputation abroad than they have done good to the country's leadership at home. They have also provided opposition groups that want the authoritarian Mr Nazarbaev to go with a useful platform.

Azamat is one of the opposition parties that decided not to collect signatures for a re-registration application. Pyotr Svoik, the party's leader, says its members knew that the law was aimed at them and believed it was hopeless to try for re-registration. But he says that, in the end, it makes no difference whether his party is registered or not. Election results are usually falsified by the election commission, he says, and so do not represent the will of the people. And only ten out of 77 seats in the lower house of parliament are filled on a party basis. The irrepressible Mr Svoik says he has every intention to run for a seat as an individual in the next election, due in 2004.

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About sponsorship

The Philippines

War without end

May 1st 2003 | PIKIT, MINDANAO
From The Economist print edition

Conflict has ravaged the southern Philippine island of Mindanao for decades. There is no end in sight

Get article background

WHEN you check in for a flight to the island of Mindanao in the southern Philippines, the airline staff ask why you want to go to such an awful spot. It is, after all, one of the few places, along with Iraq and Afghanistan, where America has sent troops to take on terrorism. It is the only place where America is sending the troops back for a second campaign, because the first had so little effect. It is the scene of near-daily clashes between soldiers and insurgents, kidnappers and bandits. Two bombs have recently exploded in its biggest city, Davao, killing 39 people and wounding over 200. A pitched battle between separatist guerrillas and the army in late April claimed another 32 lives, 11 of them civilians. What on earth is going on?

Business as usual, in some respects. First Spanish and then American colonialists found the region hard to subdue. Successive Philippine governments have never really managed it. Since the 1970s, they have been fighting and negotiating, on and off, with several different insurgent groups. The Moros, the island's Muslim inhabitants, have long resented their neglect at the hands of governments dominated by Christians and, in particular, the influx of outsiders into their homeland. There are now as many Christians from the northern Philippines in Mindanao as there are indigenous Muslims.

A peace agreement, signed in 1996 by the biggest rebel group, the Moro National Liberation Front (MNLF), was supposed to appease the Moros. It granted the cities and provinces that joined, usually after referenda, the Autonomous Region in Muslim Mindanao the power to alter school curriculums, set up Islamic civil courts, institute development schemes and even raise taxes to pay for all this. But two splinter factions, the Moro Islamic Liberation Front (MILF) and Abu Sayyaf, said that nothing but an independent state governed by fully-fledged Islamic law would do. The MILF has at least been talking to the government, as well as fighting, for the past three years. Abu Sayyaf has made no concessions at all.

The government and the MILF are due to hold their next round of talks in early May. But the odds of a breakthrough are slim. The government, says Eduardo Ermita, the president's special adviser, will not offer anything more than it gave the MNLF—in other words, jobs in the army and police for some of its members, and a few modifications to the autonomy law. What's more, the MILF's leaders can see how dismally their former comrades in the MNLF have adapted to civilian life. Nur Misuari, the head of the MNLF, proved a useless governor of the autonomous region, failed to persuade neighbouring provinces to join it in plebiscites, and then rebelled rather than face further electoral defeat. He is now in prison. The new governor, Parouk Hussin, complains that the government has coughed up only half the funds he requested from the 2003 budget.

The government, for its part, knows that any peace deal it reaches with the MILF might prove hollow, since the group's leaders exert only shaky control over the rank and file. General Generoso Senga, a senior commander in Mindanao, says that the MILF has many “lost commands” which are more interested in gangsterism than negotiations. That is certainly true of Abu Sayyaf, which long ago degenerated into a kidnapping gang. It is currently holding two Filipinos hostage.

So even as the government talks, the army seems to be going on the offensive. In February, it overran the MILF's last permanent base at Buliok—in defiance of a supposed ceasefire between the two sides. But this apparent triumph has presumably made it more difficult for the MILF's leaders to keep in contact with their followers, and has pushed the group towards guerrilla tactics and perhaps even terrorism. Since then, the MILF has increased its attacks on Christian villages and waylaid traffic on the highways more often. One of its commanders recently promised to bring Mindanao to its knees with a series of attacks on economic targets. Unlike Abu Sayyaf, the MILF denies involvement in any of Mindanao's frequent bombings. But the two deadly blasts in Davao came soon after the fall of Buliok.

Moreover, the army can never hope to win an outright military victory over the rebels. Whenever they are hard-pressed, they simply melt into Mindanao's swamps and jungles, or take off their uniforms and return to their villages. Many locals still sympathise with them, and fear the army. So, at any rate, say some of the refugees from the fighting around Buliok who are now living under tatty tarpaulins in the nearby town of Pikit. Even with American equipment and advisers, the Filipino army was not able to evict Abu Sayyaf from the island of Basilan last year. That is why the Americans plan to return.

Theoretically, Mindanao ought to be rich: its fertile fields sit amid fish-filled seas and on top of enough gold to pay off the entire national debt, according to the president. But there is little hope of attracting private investment to exploit these resources amid the current violence. Nor, given the Philippines' widespread poverty and bulging budget deficit, can the government possibly finance such development itself. That, says Abdullah Dimaporo, a congressman from Mindanao, is why it should strike any deal it can with the MILF, simply for the sake of buying time for development. Mr Ermita, on the other hand, does not seem to be in a hurry: it took 20 years of negotiations to strike a deal with the MNLF, he says, and the government is prepared to wait just as long for the MILF to come around.

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The Middle East road map

The route is mapped, now get going

May 1st 2003 | JERUSALEM
From The Economist print edition

The trouble is that, to get anywhere, the Palestinians and the Israelis need to set off at once and together

Get article background

IT HAS been an eventful week. On April 29th, the Palestinian parliament approved the government appointed by Mahmoud Abbas, the new prime minister. A few hours later, a suicide bomber, apparently a British citizen, killed himself and three others outside a crowded restaurant in Tel Aviv. Israel then retaliated, killing at least seven people in Gaza. The first act removes the latest condition for revealing the road map, an international effort to end 31 months of blood-soaked Israeli-Palestinian violence. The others underscore the urgency.

Designed by the "Quartet" of America, the EU, the UN and Russia, the road map is the most concerted effort to end the Palestinian-Israeli conflict since the 1993 Oslo accords. Spread over the next two or three years, it has three distinct phases, the first of which is to get the two peoples back to where they were before the *intifada* erupted in September 2000.

The newly reformed Palestinian police force is to resume security co-operation with the Israeli army, and to act to "end all armed [Palestinian] activity and all acts of violence against Israelis everywhere." In return, Israel is to open up the territories by gradually withdrawing from the Palestinian Authority (PA) areas it reconquered during the *intifada*. It is also instructed to freeze settlement-building straight away, a crucial step since the Jewish settlements are generally regarded as blocking all hope of a viable Palestinian state.

The plan is already several months behind schedule. The end of the first stage envisages new Palestinian elections, followed in the second stage by the setting up of a Palestinian state "with attributes of sovereignty", at first behind provisional borders covering as yet undefined areas. This state will then hold permanent-agreement talks with Israel, hoping to resolve the familiar thorny issues of Jerusalem, settlements, borders and refugees, to reach a fully-fledged peace treaty in 2005.

Leaders of the PA, old and new, are united behind the road map. Moreover, in their view, it is a done deal. "[It] must be implemented, not negotiated," says Mr Abbas, who is still commonly known as Abu Mazen. Israel demurs.

The question is where America stands on this. Israel says it has American assurances that its dozen or so

“reservations” will be taken on board in future negotiations. These include an understanding that the map will be “performance-based” rather than driven by a timetable, with all the onus on the PA to act against the armed militias. Israel also insists that any monitoring of the two sides' compliance will be by the Americans rather than by the other members of the quartet, and that the Palestinians immediately must recognise Israel's Jewish character by renouncing the Palestinian refugees' right of return.

The Americans agree that implementation of the plan should be performance driven. They have also partially agreed to Israel's monitoring demands by saying that the United States will be the arbiter on issues to do with security and settlements, leaving the other quartet members to supervise humanitarian aid and Palestinian reform. They have said nothing about Israel's demand for an outright Palestinian waiving of the right of return.

The Palestinians have been less circumspect. “It will kill the road map,” says Saeb Erekat, a senior negotiator. So, he goes on to say, will Israel's refusal to budge on the two issues of most concern to Palestinians: relaxing the closure policies, which have reduced over half the population to penury and all but destroyed the PA as a functioning government, and instituting a freeze on settlement expansion. Israel's almost non-stop building of settlements throughout the Oslo process was the single issue that most undermined the process in Palestinian eyes.

Those bothersome settlements

According to the road map, Israel has immediately to dismantle the 70 or so settlement outposts established in the West Bank during Ariel Sharon's watch as prime minister. His army says 12 will be removed in the coming weeks. But Mr Sharon has balked at the map's demand for a comprehensive settlement freeze. He knows that this could draw him into conflict not only with the far-right parties in his government but also with his own Likud movement, 18 of whose 40 members of parliament have now publicly joined forces with the settler movement to resist any freeze. Mr Sharon's preference is to have the whole settlement issue delayed until the final negotiations in 2005.

The Palestinians say that this is impossible, and not only because Israel can create a lot of facts on the ground between now and then. A settlement freeze is imperative if Mr Abbas and his government are to be true to their promise to end the armed *intifada*. In his inaugural speech to parliament, Mr Abbas denounced terrorism in all its forms, and vowed to end the rule of the armed militias in PA areas.

After two and a half years of attrition, there are probably majorities among both Israelis and Palestinians who would like to give the road map a chance. But most Palestinians believe that, even at this stage, the violence cannot be ended, either by persuasion or by force, unless the government can offer its people tangible achievements, including that settlement freeze.

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Iraq's post-war disorder

The messy path back to normality

May 1st 2003 | BAGHDAD
From The Economist print edition

Despite confusion and a ragtag of aspirants, some cities are doing well

AP

Non-communication at Falouja

Get article background

AS THE smoke of battle clears, a potentially more stable Middle East may be taking shape. America has quickly capitalised on its military gains, sharply cutting down its contentious, 13-year troop presence in Saudi Arabia, and continuing to apply pressure for reforms across the region. Yet the immediate prize of war, Iraq, remains precariously uncertain.

With reinforcements still flowing in, America's control is uncontested. But the vagueness of its plans, the bluntness of its instruments for achieving them, and the complex attitudes of Iraqis towards the occupying army all conspire to perpetuate confusion, mutual resentment and the potential for explosions.

This week's killing of 15 protesters by American troops at Falouja, west of Baghdad, was a sharp warning of the dangers. An American force in the town thought it had received local Iraqi approval to take over a school, but the action angered residents. The Muslim Brotherhood, emerging openly for the first time, stirred the crowd to mount a stone-throwing demonstration, which the Americans met with gunfire. The Americans then made matters even worse by killing some of the people who were protesting at the original deaths.

Misunderstanding of another kind has been generated by an American order banning Iraqis from carrying firearms. Nobody seems to know if this should apply to the thousands of neighbourhood watches formed to defend people against looters. And the two Kurdish parties, staunch American allies who between them have controlled the north of the country for the past ten years, now fear the decree may apply to their own 60,000-strong militias, each of which has just captured an undreamt-of arsenal of heavy weaponry abandoned by the Iraqi army.

Some small Kurdish guerrilla groups, seconded to protect opposition leaders outside Kurdistan, have already been forced to turn in their guns. In Baghdad, American soldiers hunting for weapons have mistakenly arrested members of the Free Iraqi Forces, a militia associated with Ahmed Chalabi's Iraqi National Congress, which is armed and paid by the Pentagon. The guns were eventually returned, but it is still unclear whether Mr Chalabi's group is to be allowed a monopoly, among Iraqi parties, on the right to bear arms.

Across the country, release from the leaden grip of the Baath Party has unloosed a political free-for-all. Some 60 parties, some backed by ragtag militias and others armed with little more than spray paint, have returned from exile. Scores of new, local parties have also emerged, among them tribal associations which resent the pretensions of groups they see as pampered parvenus. The parties also include Islamists who reject any separation of religion and state, and former Baathists now regrouping under new names to protect old interests.

Before the war, and after much argument, the exiled opposition had formed a 65-man committee to act as the nucleus of a future government. The Americans, and indeed most Iraqis, now insist that the forum must be expanded to include Iraqis from inside the country. Current talk is of a 150-person body, embracing the full range of sects and factions.

Negotiations to this end have started, but decisions about who to include, and in what proportions, may prove even more contentious than the original debates abroad. For example, the Supreme Council for the Islamic Revolution, an Iran-based Shia faction, won a large share of the original committee, in recognition of the Shias' 60% majority in Iraq. Inside the country, however, few Shias, and certainly not Shia secularists, accept SCIRI's claim to be the party that represents them.

Patchwork of fiefs

In the meantime, Iraq's highly centralised state has disintegrated into a patchwork of fiefs. Local leaders, some self-appointed, others imposed by the Americans or British forces, tread a wary line between claiming American support and shying away from association with the invaders.

Baghdad itself remains chaotic, although most neighbourhoods are quite safe in daylight hours. A two-week effort to assert municipal control, led by a group of returning exiles who said they were backed by the CIA, ended in farce when the Americans arrested their leader.

In most provincial cities, by contrast, basic services and security have by now returned. After a shaky start, Mosul's self-appointed leader, Mishaan Jabouri, has secured both American and local approval by establishing a large, broadly representative local council that is expected to elect a new governor this week. Mr Jabouri himself has declined the post, and also asked members of his own Jabouri tribe, the largest in Iraq, not to run.

Kirkuk is also calm, despite the fact that the two rival Kurdish parties in control of it have appointed separate governors. Karbala's government, chosen by religious leaders with broad public backing, has gone so far as to ban both opposition parties and American troops. The challenge rings of bombast, however, considering that the occupying army has stayed out of the city anyway.

Years of war, cruelty and poverty have strengthened Iraqi resourcefulness. In much of the country an air of near-normality has returned. The Iraqi dinar, always a barometer of expectations, has gained 30% on the dollar since the war. Stocks of food, drugs and fuel are adequate for the next few months, say aid agencies, and local produce now makes it to markets. But the lack of legitimate administrative authority is a growing obstacle.

City governments complain they have no powers to prosecute looters, no salary records and sometimes no access to banks in order to pay returning employees. The American civilian authority under General Jay Garner, which is supposed to advise Iraqi ministers, has little local knowledge, no ministries to use, and no Iraqi counterparts to advise.

Mr Garner has pointed to Kurdistan, whose 4m people have grown accustomed to freedom and where statues of poets long since replaced bronze Saddams, as a model for the rest of the country. But now that income from the UN's oil-for-food programme has stopped, along with the customs revenues that have been the two governments' lifeline, an economic crisis looms.

Even the task of catching wanted members of the toppled regime is handicapped by the lack of order and certainty. Sunni Arab tribes in the west, bound by a strict honour code, are widely believed to be sheltering fugitives. “Sure, I know where some of them are,” says an Iraqi official in the north of the country. But why risk associating my name with handing them over so long as I don't know what the Americans will do with them?”

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Iraq's former leaders

You see him here, you see him there

May 1st 2003
From The Economist print edition

Only Saddam Hussein's lesser henchmen are in American custody

Get article background

WHERE is the “ace of spades”? Saddam Hussein has lost power, and he may be dead. But he still takes pride of place in the pack of cards issued to coalition soldiers in Iraq to help them identify the 55 “most wanted” members of the toppled regime. So far, 15 on the list are in American custody, but those closest to Saddam remain at large.

The prisoner ranked highest on the American list is number ten, Muzahim Saab Hassan al-Tikriti, the commander of Iraq's air-defence forces, who was captured last week. The best known is Tariq Aziz, a former deputy prime minister and Saddam's chief representative to the outside world, who surrendered to American troops in Baghdad.

A steady stream of further captures and surrenders can be expected: it seems to be too late for Iraq's surviving leaders to flee the country. Syria has said that it will not harbour any of them and Iran, which fought a bitter war with Iraq, has said that if any former leaders fall into its hands, it will put them on trial itself.

The only top leader so far whom coalition forces feel confident they have killed is Ali Hassan al-Majid, known as “Chemical Ali” for his alleged role in the use of poison gas against the Kurds in 1988. Number five on America's list, he reportedly died in an air strike on his home before the end of the war.

Those closest to Saddam in American custody are two of his half-brothers, one of whom once headed the Mukhabarat, Iraq's feared intelligence service. Saddam's son-in-law and private secretary, Jamal Mustafa Abdullah Sultan al-Tikriti, was captured when he returned to Iraq after fleeing to Syria. Other notables in American hands include his chief scientific adviser, a former oil minister who had also headed Iraq's missile programme, former trade and finance ministers, and the general who served as the regime's liaison with UN weapons inspectors. But 18 of the top 20 leaders on the American list remain at large, including Saddam's two sons.

The biggest question is what has happened to the president himself. Speculation is rife that he, too, is hiding somewhere in Baghdad. Sightings of Saddam since the end of the war have been reported, and frustrated American troops have received a stream of tip-offs. An Arabic newspaper in London this week published a defiant faxed letter claiming to be by him.

Mr Aziz has told interrogators that Saddam survived the initial bombing aimed at killing him. George Bush has speculated that he was seriously wounded in a second bombing. In a fractious, overheated atmosphere, the last thing the Americans need is for Saddam, or his memory, to survive as the Scarlet Pimpernel of Baghdad.

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Iran and America

One-way signals

May 1st 2003 | TEHRAN
From The Economist print edition

Nervous Iranian conservatives may be dreaming of a quiet detente

SENIOR voices in Iran are going out of their way to avoid a set-to with America over Iraq. Mohsen Rezai, who once headed the Revolutionary Guard, calls for reciprocal measures to reduce tension. Kamal Kharrazi, the foreign minister, says that Iran will help Iraq achieve a democratic and inclusive government. Is Iran abandoning its strident anti-Americanism?

Well, so long as his pledge never to take America's side adorns a wall on one of Tehran's busiest roads, and so long as he himself continues to denounce liberal democracy, it will be hard for Ayatollah Ali Khamenei publicly to bury the old beliefs. Doing so in private may be different. With George Bush's appetite for regime change whetted, there are good reasons for the supreme leader, who has the last word on foreign affairs, quietly to endorse a U-turn.

Until now, it has been the reformists who have been pressing for better relations with the United States, and the conservatives, led by Mr Khamenei, who have regularly obstructed them. But this, after Iraq, could be changing. Some conservatives appear to have reached the conclusion that reopening relations with America may be the safest way to win themselves another decade in power.

This is a prize that some of them may be unwilling to share with their fellow conservatives. Ali Akbar Hashemi Rafsanjani, an influential and pragmatic conservative, has even suggested that relations with America might be restarted without consulting the supreme leader. His presumption was punished with a blistering rebuff, written by a hardline editor, presumably at Mr Khamenei's behest.

The supreme leader does not allow anybody to challenge his authority, but he probably agrees with Mr Rafsanjani that the time is ripe for a quiet detente. Iran's ambassador to the United Nations criticises America in such reassuring terms that he could just as well be representing France or Germany, not a founder member of George Bush's axis of evil. And the supreme leader himself, during the war on Iraq, was benignly indifferent to the British missiles that landed on Iranian territory.

Mr Rezai, a strong ally of Mr Rafsanjani's, complains that Iran goes unrewarded for its emollience. He cites America's confirmation that its forces have reached a ceasefire with units from the Peoples' Mujahideen (MKO), the armed Iranian opposition group based in Iraq. According to Mr Rezai, Iran had been assured by Britain that the MKO would be bombed out of existence.

Instead, the Americans left the MKO's headquarters intact, bombing a couple of deserted camps. Though the State Department has listed the movement as a terrorist organisation, Mr Rezai fears that the United States will use the Mujahideen, especially its political cadres in Europe, against the Iranian regime. Yet, even at his most angry, Mr Rezai is careful these days not to use terms that threaten America.

The irony of the conservatives' new stand is not lost on President Muhammad Khatami, the dispirited leader of the failed reform movement that believed, with more sincerity than success, in doing a deal with America. If anything, Mr Khatami's distrust of America, and especially of Mr Bush, has risen in proportion to the conservatives' lurch towards detente. In meetings of the National Security Council, it is now Mr Khatami, rather than his rivals, who speaks out against concessions.

But no return signal

None of this matters much in Washington, where the administration hardly bothers to distinguish

between Iranian reformists and conservatives. Though there are flying rumours that a member of Mr Rafsanjani's entourage has met a senior American official, there is no real sign that either friendliness or belligerence is having much effect.

America, laments Ali Tajerniya, a parliamentary reformist, has no strategic reason to establish relations with Iran. Not yet, perhaps, but what if Iran were to unveil the fruits of its surprisingly sophisticated nuclear programme? Conservatives and reformists alike resist demands that Iran accept more stringent inspections of its nuclear sites: they fear being de-fanged, like Iraq. Mr Rezai praises Syria's rebuttal of America's demand that it allow inspections of its alleged chemical weapons programme. Giving in, he says, would have led inexorably to the entry of American troops into Damascus. The lessons of Iraq and still defiant North Korea have come to seem rather pertinent to Iran.

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Zimbabwean rumours

Reading tea leaves by candlelight

May 1st 2003 | HARARE
From The Economist print edition

Is Robert Mugabe really planning to retire?

Get article background

Reuters

Old regime, new money, no fuel

WORKERS arrived at a factory in Harare at 7am, donned their protective goggles and overalls, and started the production line humming. Three hours later, without warning, the electricity was cut off, and every cog and motor clunked to a halt. The power stayed off for four hours. By the standards of say, Nigeria, a four-hour blackout is no big deal. But Zimbabweans are used to uninterrupted electricity, so they find such things disconcerting. Also, unlike Nigerian industrialists, they rarely have back-up generators.

It is as good a symbol as any of Zimbabwe's decline. In the past five years, as President Robert Mugabe has pursued ever-more radical economic policies, such as seizing private property, printing stacks of money and seeking to dictate prices, Zimbabwe has steadily de-industrialised. Shortages are common, of everything from bread to car parts, so it was only a matter of time before electricity joined the list. The state power company, ZESA, has not paid for the power it imports, so suppliers in neighbouring countries are finally cutting off the juice.

The more optimistic Zimbabweans are wondering, however, if the increasingly frequent blackouts might have a silver lining. Zimbabwe imports 35% of its power from Mozambique, Congo and South Africa. The first two countries are much too poor to subsidise Mr Mugabe, and have responded to Zimbabwe's non-payment of its bills by reducing the amount they supply. South Africa, however, is richer, and has a president, Thabo Mbeki, who is anxious to not to precipitate chaos in Zimbabwe. So the South African state electricity firm, which supplies 15% of Zimbabwe's requirements, has so far kept on supplying, despite an unpaid bill of $115m. But what if South Africa were to use electricity as a tool to persuade Mr Mugabe to give up the other sort of power?

Mr Mbeki could probably topple Mr Mugabe with the flick of a switch, but he prefers diplomacy. Next week, with the presidents of Nigeria and Malawi, he is to pay Mr Mugabe a visit, in the hope of “encouraging dialogue” between Zimbabwe's ruling party, ZANU-PF, and the main opposition party, the Movement for Democratic Change (MDC). The MDC hopes that the visiting heads of state will discuss Mr Mugabe's retirement, and the holding of a fresh, internationally-supervised election to supersede last year's rigged one.

Mr Mbeki's spokesman denied it, telling Reuters, a news agency, that “It is not for the president of South Africa to go to another sovereign country and tell the leader to step down.” But many Zimbabweans think that something is afoot. Mr Mugabe encouraged such speculation this week with a cryptic remark on state television. He seemed to say that now that he had redistributed white-owned farm land to blacks, his work was done. His exact words were: “It was mainly the land issue actually that needed to be addressed before getting to a stage where we say fine, we have settled this matter and people can retire.” His information minister insisted, however, that Mr Mugabe had every intention of staying in office until his term expires in 2008.

The MDC says it is ready for talks with the government, although it is wary of being co-opted, as the last serious opposition movement was. Morgan Tsvangirai, the MDC leader, said he was willing to give the visiting presidents a chance to mediate, so long as they remain impartial. In the past, they have tended to side with the regime and scorn the MDC, so neither Mr Tsvangirai nor his supporters trust them.

In recent weeks, Mr Mugabe has faced increased pressure at home. A three-day strike last week brought cities to a halt. A two-day strike last month was equally avidly observed. The MDC's latest campaign of newspaper advertisements shows photographs of torture victims' gruesome injuries and the slogan “Change demands action”, which is also scrawled on township walls. But there have been no large demonstrations, because potential demonstrators fear ending up with their picture in the papers.

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Correction

May 1st 2003
From The Economist print edition

Our article on "Managing transitions" (April 12th) appeared in print without a footnote acknowledging the work of Richard Caplan, of the Centre for International Studies at Oxford University, whose work "A New Trusteeship?: The International Administration of War-Torn Territories" was both used and quoted extensively. We apologise to him.

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Europe's defence

Will a quartet of Euro-enthusiasts undermine NATO?

May 1st 2003 | BRUSSELS
From The Economist print edition

A new plan for European defence co-operation is attracting scant support. But it could yet hurt transatlantic defence co-operation

“MY FEAR is that if we don't deal with the world on the basis of a partnership between Europe and America, then we will in a sense put back into the world the divisions that we wanted to get rid of when the cold war finished.” So said Tony Blair on April 28th before—appropriately enough—flying off to Moscow and a distinctly frosty meeting with President Vladimir Putin, who openly mocked the British leader for the failure, so far, to find weapons of mass destruction in Iraq.

In truth, however, Mr Blair's warnings about the dangers of confrontation between Europe and America were directed not so much at Russia as at France and Germany. While he was in Moscow, the heads of government of France, Germany, Belgium and Luxembourg were meeting in Brussels to foster a European defence initiative. The fact that this was the same quartet of European countries that had been most vociferously against the American-led war on Iraq made the meeting's timing distinctly pointed. True, at a closing press conference all four leaders were at pains to stress that they remained committed to a transatlantic partnership and had no desire to undermine NATO. But the details of their announcement rang alarm bells across town at NATO's headquarters, as well as in Washington and London.

Reasonably enough. By announcing that they intend to set up a separate headquarters for planning European Union military operations, the four leaders crossed a clear “red line” drawn by supporters of the Atlantic alliance: that any new EU defence plan should not compete with NATO or duplicate its capabilities. And concern that the new alliance might do just that was stoked by the quartet's suggestion that the EU should adopt a common security clause—an idea that sounds like NATO's mutual security guarantee, minus the Americans and Canadians.

Building a European defence capability has actually been a cause Britain has championed in recent years. But the British vision differs from the one advanced at this week's Brussels mini-summit in two big respects. First, it is scrupulous about ensuring that the EU's and NATO's efforts shall be complementary, not contradictory. Second, it is far more concerned to deal with European defence's real problem: the growing gap in military muscle between the United States and the EU.

This is yawning ever wider. The United States' military budget is almost double that of the other 18 countries in NATO put together. It spends 3% of its GDP on its armed forces, France and Britain around 2.5%, Germany just 1.6%. And Europe not only spends less, but spends worse, pouring money into military pay and pensions, while skimping on what really matters, equipment.

The results can be embarrassing. When Germany needed to move troops to Afghanistan to take part in peacekeeping operations there, it had to lease transport planes from Ukraine. Last December, when reinforcements were called for, the Germans found that the Ukrainian planes were no longer available: they had been leased instead to Japanese companies to ship toys to Europe for Christmas.

It was in large part to counter the capabilities gap that Britain and France launched an EU initiative at the end of 1998. After a faltering start, this European security and defence policy has made a lot of progress. After months of wrangling, the EU and NATO reached an agreement last December to let the EU have access to NATO resources. This deal is meant to help overcome the EU's own military shortfalls and guarantee that NATO and the EU work together as partners.

Just over a month ago, the EU launched its first-ever peacekeeping operation, in Macedonia, drawing on NATO resources; the EU force is a forerunner of a much-touted EU rapid-reaction force that is supposed—perhaps by the end of this year—to be ready for deployment in trouble spots at 60 days' notice. In February, for all their disaccord about Iraq, Mr Blair and France's President Jacques Chirac met in Le Touquet and made further joint commitments about defence. Their emphasis was on developing capabilities—for example, by creating an EU agency to encourage countries to harmonise their military requirements and co-ordinate research and development and procurement.

Puny Europeans, muscular Uncle Sam

Spending on military equipment, 2001, $m

	Research and development	Procurement	Total
United States	39,340	59,878	99,218
Total EU	9,100	27,442	36,542
Britain	*3,986*	*8,597*	*12,583*
France	*3,145*	*5,450*	*8,595*
Germany	*1,286*	*3,389*	*4,675*
Italy	*291*	*2,291*	*2,582*
Netherlands	*65*	*1,341*	*1,406*
Spain	*174*	*1,062*	*1,236*
Turkey	50	2,517	2,567
Canada	121	1,295	1,416

Source: International Institute for Strategic Studies

That initiative by Europe's two most serious military powers, concentrating on the real issues, is clearly likelier to achieve practical results than the Brussels mini-summit, where very little was said about capabilities. There were barely-suppressed titters when the four leaders told the press that their new defence initiative would draw on Belgium's commandos and Luxembourg's reconnaissance forces.

But the Brussels mini-summit was politically telling. However much the four leaders protested, there is little doubt that their goal is ultimately to downgrade NATO in favour of an independent European military force. That is certainly how many other EU countries see it. Several have been scathing. Before the mini-summit even convened, Franco Frattini, the Italian foreign minister, said he would “regard with a very critical eye” any “embryo of an increased military co-operation”. Ana Palacio, Spain's foreign minister, asserted that the quartet meeting in Brussels had no right to call their defence initiative “European”, since they represented a minority within the Union. Jaap de Hoop Scheffer, the Dutch foreign minister, commented that neither France, Belgium nor Germany could guarantee Dutch security, adding, “I cannot imagine a world order built against the United States.”

Such a string of rebukes, from countries that have long been among the keenest supporters of European integration, illustrates how deeply divisive the four-country defence initiative will be. For the past 50-odd years there has been a tacit understanding in the EU that while economic and even political integration could be built within Europe, security would remain primarily a transatlantic affair. France, Germany, Belgium and Luxembourg are moving towards repudiating that bargain. But there is little evidence yet that the rest of the EU is ready to follow.

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The French family

Keep it up

May 1st 2003 | PARIS
From The Economist print edition

France's government says it wants to bolster the family

Get article background

“FAMILY policy is an investment in society,” declares France's prime minister, Jean-Pierre Raffarin. Put another way, it means the state will stump up some *euro*1.2 billion ($1.3 billion) a year both to boost the nation's birth rate and to make it easier for France's mothers to rejoin the labour market.

The hard-hearted or the childless might think the measures announced this week, at the annual Conference of the Family, attended by ministers, trade unionists and family lobbies, are not exactly urgent. After Ireland's, France's women are the most fertile in the European Union, with 1.9 children per woman of childbearing age. In contrast, in neighbouring—and traditionally even more Catholic—Spain and Italy the figure has collapsed to a mere 1.2. Moreover, there are already plenty of allowances and tax benefits for French parents, so why add to them in a climate of economic gloom? The economy shrank at the end of last year, and the state's budget deficit looks likely to grow to 3.7% of GDP this year from 3.1% last year.

Yet the finance ministry's doubts seem to have been swept aside. One reason is that President Jacques Chirac promised an allowance to “welcome the new child” in his re-election campaign last year. This turns out to be, from January next year, an *euro*800 “birth bonus”, given in the seventh month of pregnancy, which will unify four existing allowances and be available to 90% of mothers, compared with some 75% now.

A second reason is that “the family” has been a political obsession in France not just for decades but for centuries. As long ago as 1804, the individual's obligations to his or her family were spelled out in the Napoleonic Code. In 1870, after France's defeat by Germany, there were calls for the French to produce more children, to overcome the nation's supposed demographic weakness. In today's France, Jean-Marie Le Pen and the rest of the far right say that larger French families (white ones, they mean) are the only answer to the assorted evils of immigration, globalisation and the EU.

There is a third reason. As Ernest-Antoine Seillière, president of the bosses' association, argues: “The phenomenon of an ageing population must clearly be balanced by an increased flow of births.” To which economists would add a need to get more women into the workforce: only a quarter or so of women with two children, one of them under the age of three, have full-time jobs. The government, more sensibly arguing that the mothers of young children should have a real choice of whether to work or not, will now offer them allowances during maternity leave, to help them stay at home. But it also promises another 20,000 crèche places, to help them go to work.

But what if all of this is, for the moment, unaffordable? Mr Raffarin has the answer: “Our attachment to the family surpasses economic logic.”

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Justice and politics in Italy

Trials and tribulations

May 1st 2003
From The Economist print edition

An embarrassing conviction for the prime minister's friend

Get article background

CESARE PREVITI, one of the closest friends of Silvio Berlusconi, Italy's prime minister, is a crook. At least that's what a court in Milan decided on April 29th. It found Mr Previti guilty of bribing judges in Rome to obtain rulings favourable to two clients of his legal practice, and sentenced him to 11 years in jail.

Mr Previti is certain to appeal against the verdict. Whoever loses at the intermediate appeal stage is sure to resort to the Supreme Court, a process that could take at least another two years.

The verdict came in two trials (known as IMI-SIR and Mondadori, after the companies involved) which had, in effect, been rolled into one, as the two had defendants in common. Also found guilty were two of the judges who took bribes, both Mr Previti's fellow-bribers and two members of the Rovelli family, which was one of Mr Previti's clients. One defendant in the IMI-SIR case, a former judge, was acquitted.

Mr Previti's other client in one of the cases under judgment was Mr Berlusconi. Along with Mr Previti and several others, he is also a defendant in a third judge-bribing case, known as the SME trial (after a food conglomerate of that name), which is expected to finish next year.

So where do the verdict and sentence leave Mr Berlusconi? In difficulty, because Mr Previti, now found guilty in the Mondadori case, was acting in the interest of Mr Berlusconi, who gained control of Mondadori, an Italian publishing group, in 1991 after a bitter battle with Carlo De Benedetti, a rich businessman. The prosecution alleged that Mr Berlusconi, via intermediaries who included Mr Previti, bribed an appeal-court judge, Vittorio Metta, who was sentenced this week to 13 years in jail, with 425m lire (then worth around $335,000) to rule in his favour in a case that decided the battle with Mr De Benedetti.

The Supreme Court quashed judge-bribing charges in this case against Mr Berlusconi, under a statute of limitations, on the eve of Italy's general election in 2001. This was instead of absolving Mr Berlusconi of the offence, as he had requested.

Controversy has dogged all three judge-bribing trials. New legislation passed by Mr Berlusconi's government in October 2001 was used to challenge the admissibility of the prosecution's evidence, but the courts were unmoved. Similarly, Mr Berlusconi and Mr Previti did not succeed in their attempts earlier this year to use new laws to get their trials transferred from Milan, where Mr Berlusconi and his friends say judges are biased against them.

The past two weeks have been no different. On April 26th, just as the three trial judges in Milan were, for the fourth time, about to retire to consider their verdicts, Mr Previti held a press conference in Rome to announce his seventh request to have them replaced. Milan's appeal court, having rejected his sixth request just two weeks ago, promptly rejected his seventh on April 29th, thus allowing the trial judges to make their verdicts.

But this was only after the president of the three trial judges, Paolo Carfi, had turned down a plea from Mr Previti, a member of parliament for Mr Berlusconi's ruling Forza Italia party and a former minister of defence, to postpone the verdicts. Mr Previti wanted a delay until the final appeals court had ruled on his appeals against the recent rejection by Milan's appeal court of his sixth and seventh requests to have the trial judges replaced. The basis for Mr Previti's plea was the damage to his political health and personal wealth that would flow from a guilty verdict, even if overturned on appeal.

Italy's television stations have been rather more receptive to Mr Previti's words. Extracts of his press conference were broadcast on news programmes by RAI, the state broadcaster. Rete 4, a commercial channel owned by Mediaset, which in turn is controlled by Mr Berlusconi's family, was even more helpful. It ditched a history documentary on the eve of the verdict so that its viewers could watch Mr Previti make his case to the press.

“We have a fantastic relationship in every respect,” Mr Previti said of his friendship with Mr Berlusconi. Indeed, ever since he returned to power nearly two years ago, Mr Berlusconi has stood shoulder to shoulder with his co-defendant. He turned up—outside the courtroom—at the SME trial two weeks ago in a show of solidarity for his friend, telling journalists that Mr Previti was a “persecuted politician”.

As well as claiming to be a scapegoat and victim of a political trial, Mr Previti launched an angry assault on bias among the Milanese judges and on the honesty of his prosecutors. It was they, he said, who should be investigated and punished. Roberto Castelli, the justice minister, told a newspaper that he had asked the Milan courts about allegations in a dossier submitted to him by Mr Previti.

Here the affair gets serious for Italy, not just Mr Berlusconi. After the verdict, the prime minister called for stronger parliamentary immunity, denouncing “politicised judges” who cannot be allowed “to choose for themselves, with coupsters' logic, the government that they prefer”. The council of the judiciary replied furiously that the judges' “honour and impartiality” had been insulted. It is not the first such clash, but it is the worst yet.

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Ireland and alcohol

Slainte

May 1st 2003 | DUBLIN
From The Economist print edition

The Irish are hard drinkers—too hard, says their government

ONCE the fastest-growing in Europe, the Irish economy has slowed. Not so the Irish drinking that the boom years encouraged. Now the demon drink has become a matter of public concern.

The boom was huge: even this year, in a slow-growing world, Irish GDP is expected to grow at 3.2%. But that is only a third of the rate during the best “Celtic tiger” years, which also saw a surge in alcohol sales. Between 1989 and 1999, booze consumption per person rose by 41%, the highest increase in the European Union, and one that put the Irish near the top of the EU drinkers' list, despite Ireland's high taxes on wine and spirits.

The result today, hangovers apart, is an increasingly animated debate about the dangers of hitting the bottle. The nation's president, Mary McAleese, has recently joined in, calling her countrymen's attitude to drink “unhealthy” and even “sinister”. The government is counting the costs, social and economic, and aims to alter attitudes and behaviour. But in a society long tolerant of excessive drinking, it has a job on its hands.

A recent health survey underlined just how big a job. In 1995, 35% of Irish men were classified as binge drinkers, consuming more than six drinks in one session. By last year that figure had risen to 41%. Among women, the figure rose from 12% to 16%. Today one in four of all cases treated in Irish hospitals' accident and emergency units is alcohol-related. So is one road accident in three, and two in five of all fatal road accidents.

One estimate puts the overall cost of excessive boozing at nearly 2% of GDP: in lower productivity when drinkers do not turn up for work, in extra crime, particularly public-order offences, and simply in higher health-care costs. The justice minister, Michael McDowell, plans to change the law to counter under-age drinking, with heavier penalties for drunkenness and mandatory identity cards—a voluntary scheme flopped—for young drinkers. Here's to him.

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Turkey's generals

Brasshats v headscarves

May 1st 2003 | ANKARA
From The Economist print edition

Islamic habits worry the meddlesome soldiers

WHAT is the real danger? The Islamic headscarf, as the generals think? No, says Bulent Arinc, speaker of the parliament and a member of the governing Justice and Development Party (AK): it's the *dekolte*, or rather, when not on Turkish bosoms, the décolleté. To many Turks the risk is neither: it is the fresh bout of sparring between the men in uniform and the country's five-month-old government.

This has erupted anew now that the war in Iraq is over. The generals fired the opening shot, when they and the like- minded national president, Ahmet Necdet Sezer, failed to show up at a reception last week to mark the founding of Turkey's parliament, having learned that Mr Arinc's wife would attend wearing—ah, horrors—her headscarf. In the end, she did not turn up. But her husband later chose to comment on some of the more revealingly clad guests who had, and the battle was on.

The generals have not disguised their distaste for AK and its leader, Tayyip Erdogan, the new prime minister. He began his career in an overtly Islamic party, as did a fair number of AK's founding members. Yet, when they were swept to an overall majority in the election of November 3rd, Mr Erdogan reassured the nation that he had no intention of deviating from Turkey's solidly pro-western and secular policies. And the issue of the headscarf, banned in government offices and schools,was not urgent, he said.

But then some of his ministers began to speak. Zeki Ergezen, the public-works minister, said he did not think Turkish contractors should take part in reconstructing battered Iraq because their gains would be “tainted by Iraqi blood”. Abdullah Gul, briefly prime minister and now foreign minister, instructed Turkish embassies abroad to socialise with members of some rather shady pro-Islamic outfits.

Told you so, cried the pro-secular elite, declaring that AK's mask had fallen. The National Security Council (NSC), in which the generals lay down the law to the politicians, this week issued a clarion call for the defence of secularism. But few Turks, fed up with decades of corruption and mismanagement by AK's secular predecessors, seem ready to believe in the Islamist bogeyman this time. Indeed, in an unprecedented display of courage, the press has been mocking one of the topmost brasshats, General Tuncer Kilinc, secretary-general of the NSC. At a recent meeting of Turkish associations in Brussels, he had opined that Turkish women cover their heads not for religious reasons but for protection against wind and rain, that Turkey's financial woes could be solved by printing more money, and that the PKK, a Kurdish separatist guerrilla group, had been created by the European Union. For some reason, the press found this funny.

There are more serious issues. The government's belated embrace of an IMF programme last week earned it a long-delayed $700m tranche from an $18 billion stand-by agreement. Some of the measures the Fund insists on in exchange threaten what Turks call the “deep state”, a coalition of forces within the army, the security services and the bureaucracy, who remain deeply opposed to democratic reforms that would challenge their power.

Some must now go, thanks to a new law reducing the age of retirement from 65 to 61. Bad news for them, but also, they say, for Turkey: AK, they claim, is filling their places with its pro-Islamic cronies. How come the new chairman of Turkey's largest state bank, Ziraat, is Zeki Sayin, who worked under Mr Erdogan during his days as mayor of Istanbul, and later became head of an Islamic finance house? Why replace Cem Kozlu, the man who turned around the national airline, with another of Mr Erdogan's former associates?

The old guard might better be asking why a swelling number of cabinet ministers' relations are being given plum posts. Wasn't AK elected to fight corruption and nepotism? It was. But why remind voters?

Who were the nepotists then?

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Sweden and the euro

Persson calls the tune

May 1st 2003 | STOCKHOLM
From The Economist print edition

The pro-euro prime minister tells anti-euro colleagues to pipe down

Get article background

IS THE prime minister, Goran Persson, starting to panic about the euro referendum in which Swedes will vote in September? As support for adopting the EU currency slumps—the latest poll shows 50% against and only 34% for—Mr Persson is clamping down on anti-euro notables in his own Social Democratic Party.

Why not, one might think? But their views—shared by most of his party's rank-and-file—are no novelty and no secret: his own deputy, Margareta Winberg, is anti-euro, as is the popular trade-and-industry minister, Leif Pagrotsky, and others. And there was no party gag during Sweden's equally divisive referendum on EU membership in 1994. Yet when Mr Pagrotsky recently wrote against the euro in the party magazine, the prime minister declared flatly that it was unacceptable. Two anti-euro state secretaries also got warnings.

The reason may be precisely that Mr Persson's pro-euro campaign is going so badly: there are those opinion polls, an ever widening base—economists and bankers, not just left-wingers—for the no campaign, and his own failure to win support from LO, the powerful blue-collar trade-union body. It had demanded a gigantic buffer fund to protect Sweden's welfare state from the effects of euro membership; Mr Persson refused, fearing to alienate non-socialist support for the euro. The current slow-down in the big euro-zone economies is no help to him either.

So what was he to do? Sit back and endure an anti-euro campaign within the government from now till September? Or face a sharp but possibly short intra-party rumpus, and hope to get it over and done with now? Better the latter, he may well have thought—and he can soon expect pro-euro support from the big guns of Swedish business, other parties and the heavyweight media.

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Charlemagne

Waiting for Blair

May 1st 2003
From The Economist print edition

Britain's decision to stay out of the euro has done little damage to its standing within the European Union

Get article background

ON DECEMBER 31st 2001—the night before Europe's single currency began to circulate freely across the continent—Romano Prodi, president of the European Commission, gave an interview to the BBC. That was rather gracious of him, given that Britain had chosen to watch from the sidelines as 12 other European Union countries joined hands and leapt into the unknown. Mr Prodi uttered some platitudes about the significance of the euro, remarking that it marked a huge development in the politics of the EU. At this, his British interviewer leapt forward like a weapons-inspector who had stumbled across a sarin-tipped missile. “Aha,” he exclaimed, “so it *is* political.” Mr Prodi, a former professor, looked at his interlocutor with the pitying expression he might once have reserved for a particularly dim student. Yes, he replied gently, it *is* political.

It has always seemed odd, viewed from Brussels, that so many Britons should so resolutely insist on treating the euro as above all an economic matter, when other Europeans have never disguised the fact that they regard the single currency as primarily a “political project”. Some regard the British obsession with the economic case for the euro as an example of British mercantile pragmatism; some see it as an example of British obtuseness; to others it is a dishonest fig-leaf for an essentially political decision. Almost nobody accepts that the question of joining the euro can really come down just to the famous “five economic tests” laid out by Tony Blair's government. And yet it is those five tests that are likely to cause the British to announce, later this month, that their country will once again defer its decision over whether to sign up to Europe's single currency.

We do understand

Still, the perception gap between economics-obsessed Britain and politically-minded Europe may be narrowing. As the euro's early problems have become more evident—with slow economic growth across the euro zone and an increasing number of countries busting the budgetary rules that are meant to bind members of the single currency—there is more understanding for Britain's dogged insistence on arguing the economics out. As one senior Brussels official puts it, “At least the British are having a proper debate about the euro, which is more than the rest of us did.” For his part, Mr Blair now regularly acknowledges that membership of the euro has an important political aspect. His current debating tactic is to assert that the political arguments are “overwhelmingly” in favour of joining; all that remains to be settled are those pesky five tests.

This Blairite approach to the politics of the euro infuriates his Eurosceptic opponents in Britain. They regard joining the euro as overwhelmingly negative politically, since it involves an irretrievable loss of sovereignty. Mr Blair, in contrast, has always seen the politics of the euro as a question of influence rather than sovereignty. His ambition is to “lead” in Europe, and his supporters have always argued that such an ambition can never be fully realised if Britain continues to stand aside from the euro. For while the Blairites have a dream of an EU whose agenda is set by an ascendant Mr Blair, they also have a nightmare, in which Britain's failure to join the euro leads to the country being progressively marginalised within the EU. Under this gloomy scenario, the Union would eventually split into two groups: an integrated inner core of euro-members led by France and Germany, and a miserable smaller group of euro-outs, whose voices—on a range of issues—would be increasingly ignored.

Because Mr Blair wants to keep the option of joining the euro open, he will not want to admit that this

nightmare is now looking a lot less plausible. But the fact is that, so far, there is precious little evidence that Britain's weight in the European Union has diminished because it has chosen to stay out of the single currency. That makes it much easier for Mr Blair once again to defer the question of euro-membership.

In part, Britain's continuing influence in the EU is simply a reflection of legal realities. In or out of the euro club, Britain still has the same number of votes in the Council of Ministers and members of the European Parliament. But it is also true that the euro has not yet transformed the political atmosphere within the EU in the way some of its boosters had hoped.

Ever-grumpier union?

The theory was that the indissoluble tie of sharing a currency would lead euro-zone countries to share common interests in an ever-widening array of policies and to see the world in the same way. It has not happened. Take the most divisive and consuming political issues facing the EU: the war in Iraq and relations with the United States. Whether or not a country uses the euro has been of little help in predicting attitudes on such issues. The euro zone was divided about Iraq. It is no less divided in the clash between Atlanticism and efforts to build up Europe as a counterweight to the United States: this week, when four members of the euro area—Belgium, France, Germany and Luxembourg—met to discuss non-NATO European defence co-operation, eight other members stayed away, with some of their ministers barracking from the sidelines. Britain's absence from the euro club has not stopped Mr Blair from being one of the most listened-to politicians in Europe.

The question of whether or not Britain joins the euro still obsesses the political classes in London. But in the rest of Europe it is no longer a major topic of discussion. The big questions facing the EU now are its enlargement to 25 members next year, the efforts to write a constitution for the Union that are reaching a climax in a convention on its future, and the continuing struggle between Atlanticists and Europe-firsters. Britain will be a big player in all of these debates—whether or not it decides to take up Europe's single currency.

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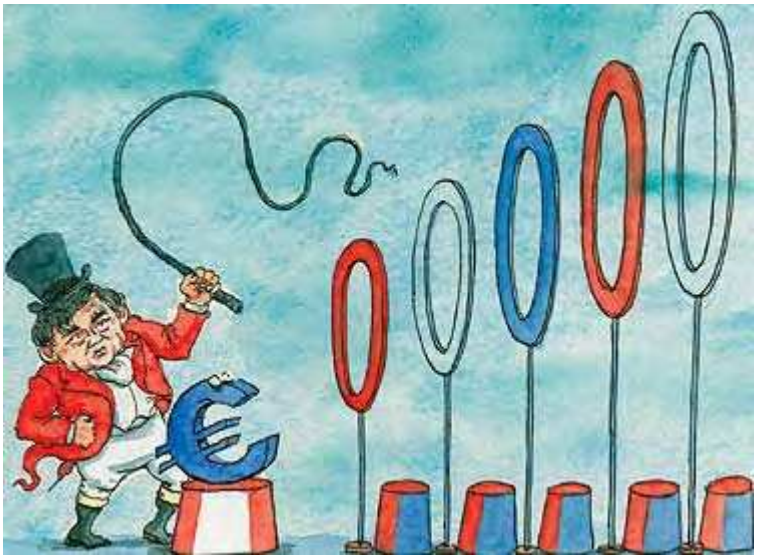
Britain and the euro

Five tests and a funeral

May 1st 2003
From The Economist print edition



Gordon Brown will soon bury the chances of Britain joining the euro before 2005

Get article background

BY THE first week of June, Gordon Brown, the chancellor of the exchequer, must announce the results of the most comprehensive study the Treasury has ever made of a single decision: whether or not Britain should join the euro. His answer will be: not yet. This will make it virtually impossible to join the euro before the next election, which will probably be in 2005.

The Treasury's analysis has spawned 18 supporting studies and will run to 2,000 pages. But at its heart are five tests, which Mr Brown first set in October 1997. Are business cycles and economic structures compatible so that Britain can live permanently with euro interest rates? If problems emerge is there sufficient flexibility to deal with them? Would joining the euro encourage investment? How would the City of London be affected if Britain joined the euro? Finally, will joining the euro promote higher growth, stability and a lasting increase in jobs?

Leaked reports suggest that four out of the five tests will be “failed”—the same result as six years ago. But whatever the pass rate, the judgment will be less damning than the dunce's report of 1997. This is especially clear with the first test, about **convergence**. Short-term interest rates are now much closer than in 1997. So, too, are output gaps, which measure whether economies are overheating or running below capacity.

So does this mean that Britain passes the convergence test? Probably not. The house-price boom of recent years has highlighted a fault line between Britain and the euro area. A house-price bust could weaken demand. As long as Britain retains its own currency, the Bank of England can respond with lower interest rates. A Europe-wide interest rate would make that impossible. Mr Brown revealed in last month's budget that he is looking for ways to make housing finance less reliant on short-term floating-rate mortgages and so less vulnerable to short-term interest rates, which suggests he thinks that Britain has not yet achieved the goal of “sustainable and durable” convergence.

What of the second test, about **flexibility** in the event of economic mishaps? At present the pound can fall if Britain's costs get out of line with those of the euro area. But once Britain joins the euro, wages will

have to fall to restore competitiveness. In 1997, Mr Brown concluded that Britain's economy was not yet flexible enough to join the euro. In his budget speech, he seemed still to be worried about the issue. With good reason: wage costs carried on rising in the trading sectors of the economy when the pound appreciated so sharply in the late 1990s. So the real loss of competitiveness was even greater. This is a further reason to doubt whether the recent fall in the pound against the euro has gone far enough.

The way that the Treasury initially assessed the second test also gives it scope to find fault on another ground: the euro area's own lack of flexibility. The European Council agreed a set of ambitious targets to unclog labour markets when it met in Lisbon three years ago. Progress since then has been disappointing.

Who's where on the euro

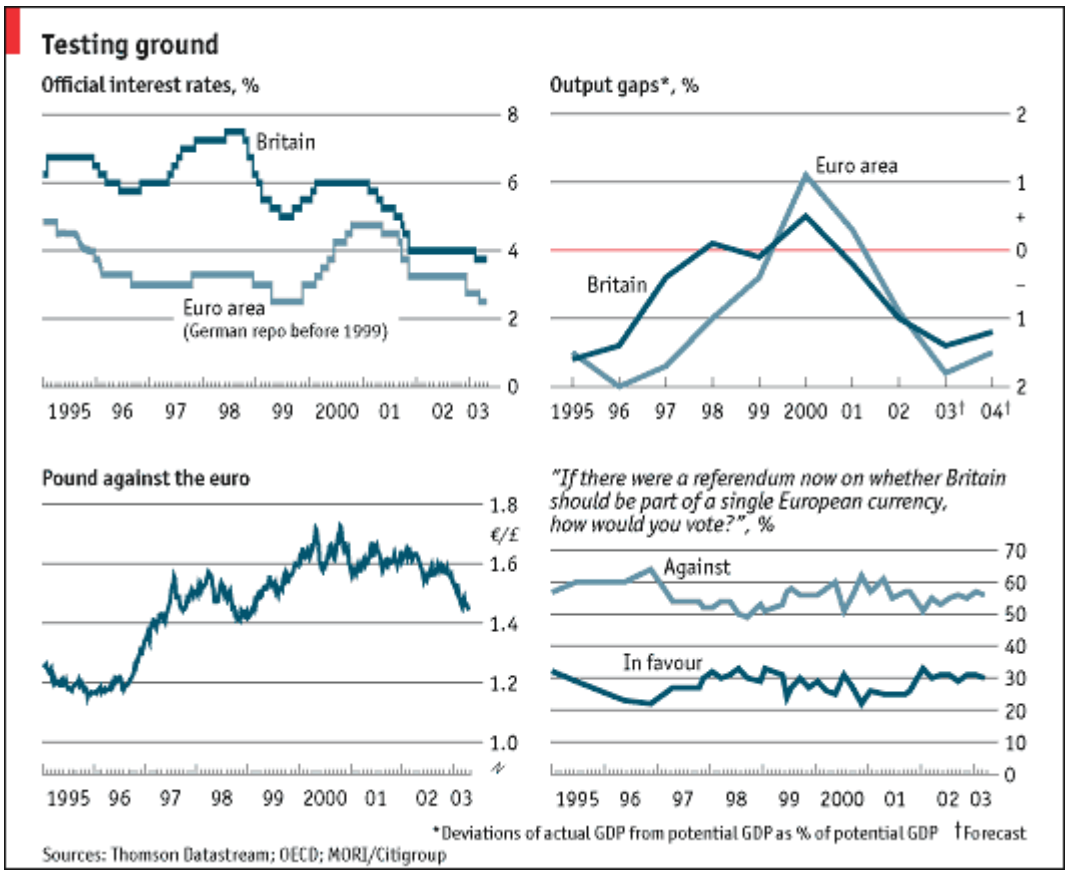
Bank of England	Publicly neutral but institutionally sceptical. Having just won power over monetary policy, not keen to give it up. Mervyn King, governor-elect, reckoned to be sceptical
Treasury	Institutionally sceptical: joining would reduce its power. Wounds from ERM debacle still raw. Critical of Europe for lagging on Lisbon flexibility agenda
Foreign Office	Institutionally keen; but Jack Straw, foreign secretary, much less of an enthusiast than Robin Cook, his predecessor
Number 10	Enthusiastic. Top Blair aides – Jonathan Powell, Sir Stephen Wall, Roger Liddle and Alastair Campbell – all very keen. Sir Nigel Sheinwald, new foreign policy adviser alongside Sir Stephen, pro-euro
Cabinet	4-5 enthusiasts and about the same number of hostiles. The rest neutral or indifferent
Labour MPs	Worries about fiscal straitjacket have grown: priority for most is to keep the spending taps open
Conservatives	Only a handful of pros these days
Lib Dems	Generally pro; some doubters
Trades Union Congress	Not as keen since very pro-euro John Monks went to Brussels
Confederation of British Industry	No longer campaigning for entry, but foreign-owned companies tend to be pro
City of London	Mostly unkeen since fears that financial services might shift to Frankfurt have proved unfounded
Press	*Financial Times, Guardian, Mirror* and *Independent* broadly pro; *Times* "not yet"; the rest anti

The Treasury will find it more difficult, however, to score the third test, about **investment**, as a "fail". For one thing, higher investment is potentially the big prize from joining the euro. Businesses will no longer have to worry about exchange-rate risk. Currency unions can give a big boost to trade; and this seems to be happening within the euro area. More trade and greater price transparency should mean more competition and thus higher productivity growth.

Set aside the potential gains in higher investment from joining the euro: staying out could mean less investment, especially from overseas companies. After several years in which Britain was usually the top recipient in the EU, its share of foreign direct investment fell sharply in 2002, according to preliminary estimates from the United Nations Conference on Trade and Development. On balance, it seems difficult to see why this test should not be marked as a "pass" unless Mr Brown invokes broader concerns about the impact on investment if Britain joins the euro before full convergence.

The fourth test is about the effect of joining the euro on Britain's **financial services**. Staying out has done the City no harm: its current difficulties arise from the general weakness of financial markets. Still, the Treasury concluded in 1997 that it would do better within the single currency area than outside it, so it is likely to stick with that assessment.

The fifth test will highlight the euro area's disappointing record on **growth and jobs**. Britain has grown faster than the euro area since its launch in 1999 and by even more in the past ten years. That looks set to continue. The OECD is forecasting that Britain will grow by 2.1% in 2003 and by 2.6% in 2004, compared with 1% and 2.4% in the euro area. And it expects Britain's unemployment rate to be 5.4% of the labour force in 2003, compared with 8.8% in the euro area. Mr Brown peppered his budget speech with such unfavourable contrasts, which suggests that the Treasury will also score this test as a "fail".



So on at least three of the five tests, the decision will be: not yet. But this judgment leaves a lot to play for. Given the clear and stable majority in the opinion polls for staying out, that is clearly the safer option politically. But Mr Blair still wants to go in. Paradoxically, a period when Britain's economy is under-performing the euro area would help him make the argument.

If Mr Blair is determined to take the gamble, the best time to call a referendum would be a few months after a third election victory—in late 2005, say. For that to happen, the Treasury's negative judgment will have to have a positive spin. The five tests are therefore likely to generate two answers. One will be: not yet. The other will be: but we're getting there. Mr Brown may bury the issue for the rest of the parliament, but it is likely to be resurrected a lot earlier than many now expect.

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Shareholder activism

Herding fat cats

May 1st 2003
From The Economist print edition

The government is bothered about fat cats. So, at last, are investors

Get article background

ANGER in America at stories of fat-cat bosses of underperforming companies (see article) has loud echoes in Britain. This week, Corus, a troubled Anglo-Dutch steel company, announced more job cuts. The lowly treatment of the sacked workers was widely contrasted with the handsome pension that Sir Brian Moffat, the outgoing chairman, will receive.

The government has climbed aboard the bandwagon. Peter Hain, the Welsh secretary, described big pay-offs as “obscene”; Patricia Hewitt, the trade and industry secretary, said shareholder revolts were “entirely justified fury”.

This year new regulations have forced companies to put directors' pay to a shareholders' vote at the AGM—one of the main reasons why meetings have been so fractious lately. Now the government seems to want directors' contracts cut to six months and put to a shareholders' vote, and to link pay-offs to performance. Two recent reports the government has commissioned, by Derek Higgs and Paul Myners, recommend, respectively, that companies should have more independent non-executive directors and that pension-fund trustees should take more notice of the companies in which they are invested.

The new regulations on directors' pay do seem to have encouraged shareholder activism, though companies' poor performance has probably been more influential. Investors are beginning to hold bosses more closely to account, not just on the question of pay, but also on broader questions. “What you're really worried about is corporate strategy,” says Lindsay Tomlinson, of the Institutional Shareholders' Committee (ISC), which represents big shareholders.

More investors are bothering to vote in shareholder meetings. In 1994, only 35% of votes were exercised; last year the figure was 55%, according to PIRC, a corporate-governance consultancy. The number of funds prepared to take a stand is rising. To activist diehards such as Hermes, a vocal fund manager wholly owned by the British Telecom pension fund, have been added others, such as Deutsche, Schroder and Morley, who are taking a generally more robust stance. Some—especially those that hold stocks for the long term and rarely sell—have been hiring corporate governance experts recently.

Industry bodies, such as the Association of British Insurers and the National Association of Pension Funds, have taken stands against companies that they think have breached important points of principle. The ABI complained to Cable & Wireless about its reluctance to return money to shareholders; to British Telecom about the huge increase in its debts when it was bidding for 3G licences; and to Marconi about huge payouts to the bosses who had taken the company to the brink. Both the ABI and the NAPF have been taking companies to task over their pay policies for several years, admittedly with limited success.

Fund managers are making their displeasure more public. The number of “No” votes and abstentions cast by institutional investors has been rising recently, according to PIRC. In 1997, only 0.5% of companies had opposition of over 20% to one or more of their motions; last year the number was 3%. The number of abstentions has risen from 2% to 6%. Abstentions are not seen by fund managers as a cop-out but as a yellow card. The number of “Noes” and abstentions is likely to be much higher this year because companies have been forced to reveal more about remuneration and put packages to the vote.

Will any of this do any good? Possibly, as long as investors do not meddle too closely. Much of the damage that investors are now trying to undo could have been avoided had shareholders been awake. If active funds do better than lazy ones, shareholder activism will get a boost. But so far, the evidence on

that is mixed.

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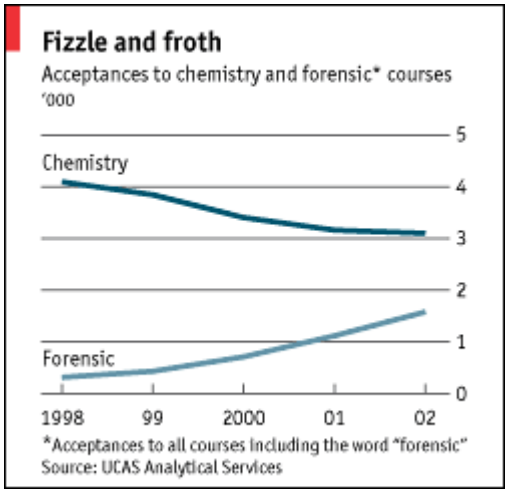
Science

Stinks tanks

May 1st 2003
From The Economist print edition

The peculiar boom in forensic science



ONE of the few reasons undergraduates still study chemistry, admits an old hand, is that they think they will be able to make illegal drugs such as ecstasy in the laboratory. The way things are going, it is not just the students, but also their teachers, who will need some chemically-induced happiness.

Chemistry in British schools and universities is in a dire state, short of money and students. The University of Kent is set to close its chemistry department, it emerged this week. That followed similar news earlier this month from Kings College London.

But there is one seeming bright spot (see chart). The numbers applying to do forensic science courses are growing fast. At first sight this might seem a welcome example of several desirable trends, such as universities repackaging their courses to meet customer demand; narrow science syllabuses widening to include real-world skills; and students realising that exciting jobs may require a core of hard scientific knowledge.

Sadly, the real story is very different. For a start, the jobs available are very few: the Forensic Science Service (FSS), the government body that employs the vast majority of graduate specialists, recruits between 70 and 120 a year—less than a tenth of the number accepted to study the subject last year. Furthermore, the FSS prefers people with good first degrees in mainstream science, not forensic science.

Secondly, most of the 360-plus undergraduate forensic science courses on offer are of dubious worth. Most are taught by academic chemists with no forensic science training or experience. They may have a few retired police specialists to add a whiff of authenticity. None match the handful of postgraduate specialist courses that employers actually find useful.

The real reason for their popularity is that the “new universities” (ex-polytechnics) that offer them are finding it very hard to attract students, especially in unpopular subjects such as science. Forensic science, especially as portrayed in detective fiction, is a much easier sell. “Young people are seduced by what they see on the television—it seems extraordinarily glamorous,” says David Giachardi, who heads the Royal Society of Chemistry. In fact, though, the students are getting neither a vocational course, nor enough core science to fit them for jobs elsewhere.

History suggests this bubble will burst. That was the case with environmental science, a similarly blurry discipline which was very popular in the mid-1990s, when students thought it would train them to save the planet, but found the job market strangely indifferent.

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Northern Ireland

At least it's clear

May 1st 2003
From The Economist print edition

Tony Blair has put Northern Ireland's peace process on hold

Get article background

“ALL problems are from now on resolved politically. They are not resolved by a mixture of politics and paramilitary activity.” After weeks of uncertainty and comings and goings between London, Belfast and Dublin, Tony Blair's statement on May 1st could not have been clearer. The elections due on May 29th have been postponed and Northern Ireland's devolved government remains suspended until the IRA commits itself absolutely clearly to giving up all paramilitary activity. The “creative ambiguity” which had characterised earlier stages of the peace process was no longer useful, said Mr Blair. “It is a different world.”

The argument that led up to this announcement was, ostensibly, about a few words. The British and Irish governments have been trying to get a statement out of the IRA saying that it is giving up “military attacks, training, targeting, intelligence-gathering, acquisition or development of arms or weapons, other preparations for terrorist campaigns, punishment beatings and attacks and involvement in riots”. After three weeks of negotiations and drafts, Gerry Adams, head of Sinn Fein, the political wing of the IRA, which was part of the suspended government, issued a statement saying that there would be “no activities which will undermine in any way the peace process or the Good Friday Agreement”. That was not enough.

Mr Blair did not attack Mr Adams: he was quite polite about the Sinn Fein leader's efforts to keep the peace process alive. But he went out of his way to shower praise on David Trimble, leader of the Ulster Unionists, who is risking his political career to keep the peace process going.

Mr Blair must have calculated that the IRA statement was not enough to vindicate Mr Trimble's support for the Good Friday Agreement in Unionist eyes. If the election had been held when Mr Trimble's credibility was low, Ian Paisley's hard-line Democratic Unionist Party might well have overtaken the UUP. That, as Mr Blair made clear in his statement, would be the end of power-sharing between Unionists and republicans, and a settlement would be even further away than it is now.

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Transport

Euroflop

May 1st 2003
From The Economist print edition

Eurostar is doing so badly that another government bail-out will be needed

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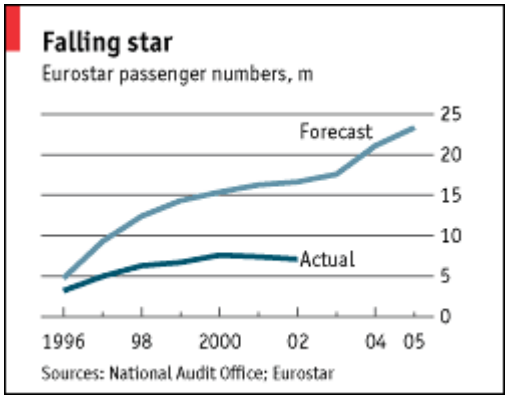

PRESTIGE projects have a nasty habit of landing taxpayers with large bills. True to form, the first new railway to be built in Britain for more than a century, the high-speed rail link between the Channel Tunnel and London, is in deep financial trouble. The National Audit Office (NAO), which published a scathing report on the project only two years ago, is so concerned by its deteriorating financial position that it has decided to launch a second inquiry. Another government bail-out, of probably more than £1 billion, is likely.

Passenger numbers on Eurostar's London-Paris route are the problem (see chart). They are below the most pessimistic forecast made in 1996, when London & Continental Railways (LCR) was granted its licence. The next set of forecasts, which the government commissioned in 1998 when the company was financially restructured, was less optimistic. Even so, the numbers are worse than the government's worst-case, which ministers claimed “was most unlikely to materialise”.

The problems piled up. First came competition from low-cost airlines, then came September 11th and war in Iraq. In 2002 Eurostar attracted 7.1m, a drop of nearly 5% on the previous year, and half LCR's original forecast. The gap between Eurostar's revenues and the access charges it has to pay Network Rail and Eurotunnel is therefore growing.

The government has two alternatives. Under its agreement with LCR, it has the right to take Eurostar into public ownership if it performs for two consecutive years below the “downside case”. That point has almost been reached. But the government has no wish to nationalise Eurostar. Since letting the company go bust is reckoned to be politically unacceptable, the only alternative is to give it more cash.

It is still unclear just how large a bail-out will be needed, and when. Two years ago, the NAO suggested that the sums involved were likely to be at least £360m and could, in certain circumstances, reach £1.2 billion. Since then, Eurostar's financial position has deteriorated. The government has also guaranteed nearly £4 billion of bonds used to finance the link. Conveniently for the Treasury, these bonds are not rated as public borrowing because the risk of default was declared by the then paymaster general, Geoffrey Robinson, to be “infinitesimal”.

Rob Holden, the chief executive of LCR, denies there is any immediate crisis and says that Eurostar is in a position to meet its first scheduled bond repayment due in 2010. He does admit, however, that further government support may be necessary.

In Eurostar's favour, the first section of the 68-mile (109km) link is due to open this September on time and on budget. It will cut 20 minutes off the roughly three-hour London-Paris route. The journey will be reduced by a further 20 minutes when the second section is completed in 2007. Faster journey times are bound to improve Eurostar's competitive position. So will a planned reorganisation of the company into a single entity. Its current structure—control is split between French railways, Belgian railways and Eurostar UK—is a recipe for trouble.

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School privatisation

Economics lesson

May 1st 2003
From The Economist print edition

Privatising state education has had mixed results

Get article background

FROM the howls of protest, one would think the Goths were at the gate. The education establishment greeted with horror the news that Jarvis, a firm best known for a less-than-stellar perfomance in railway maintenance, had won a three-year £1.9m contract to advise the 700 worst secondary schools in England. John Dunford, of the Secondary Heads' Association, said he was “shocked”; David Hart, from another headteachers' union, said it was “extraordinary” and “inappropriate”.

Ideology aside, the carpers have a point. The record of privatisation in education is mixed. The disappointments have been biggest when private companies have tried to take over local education authorities (LEAs). The largest contract so far was a five-year £100m deal in 2001, between WS Atkins, an engineering firm, and the London borough of Southwark. It has ended in a shambles. WS Atkins says it is not making enough money to continue and wants to walk out now. The council and the government are frantically working on a stop-gap arrangement to get through to the end of the summer term, and plan a not-for-profit trust after that.

Other such privatisations have had similar hiccups. There are two fundamental problems: weak and inexperienced private contractors, and rigid and over-detailed contracts. WS Atkins took on the Southwark project as a loss leader, hoping that there would be similar contracts in the pipeline. In fact, there has been only a trickle of deals, and the company's finances have worsened sharply because of problems elsewhere.

Even the strongest private company would struggle to deal with being micro-managed by elected councillors. “You basically have to run it just as if it were still in the public sector,” complains Kevin McNeany, head of Nord Anglia, the country's largest private education company. Chris Woodhead, a former chief inspector of schools, says that the privatisations have been “half-cock and illogical”.

The successes have been in the simplest kind of privatisation—contracting out ancillary services, Dame Marlene Robottom, headmistress of Mulberry School, an award-winning girls' comprehensive in Tower Hamlets, cut her annual cleaning bill from £100,000 to £62,000—gaining “a teacher and a half”, she says.

Another kind of private-sector involvement is through the private finance initiative, providing premises. Mulberry's tatty buildings are being refurbished under a £19m deal with a private contractor who will also maintain them for the next 27 years. Heads may like these deals, but economists worry that they are an expensive way of financing public investment.

The government's current push, as the Jarvis contract shows, is private provision of services to school managements. There have been some successes here too: a task force headed by Nord Anglia has played a big role in helping turn round St George's, a London school where the headmaster was killed protecting a pupil from attack.

The government is determined to sort out the country's worst schools, if necessary by closing them. A private-sector intruder nosing around may have a salutary effect on both incompetent headteachers and the bureaucrats that shelter them.

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Law

Silks' purses

May 1st 2003
From The Economist print edition

Abolishing Queen's Counsels may lead to more fundamental reform

DRESSED in silk tights, knee breeches, buckled shoes and full-bottomed wigs, 121 aspiring lawyers were appointed Queen's Counsels this week. After the ceremony in the House of Lords, many of the new “silks” got drunk to celebrate what a High Court judge describes as their “licence to print money”.

But this glorious piece of flummery, dating back four centuries, is on the way out. It was Elizabeth I who created an elite band of lawyers to advise the monarch. It has fallen to an equally imperious figure, the Lord Chancellor, Lord Irvine, who is responsible for their appointment, to get rid of them. The government is to publish a consultation paper later this summer. Lord Irvine claims no decision has yet been taken. But no more applications for silk are to be accepted for the time being; and reform is forcing itself on the system.

Opposition has been growing steadily. Two years ago, the Office of Fair Trading (OFT) branded the club “uncompetitive” and said such an official kite mark of quality was not needed. Even the Bar Council, which represents barristers, believes that the current secret method of appointment of silks is unsustainable and that in future they should be selected by a small panel chaired by a retired High Court judge.

Whether this will have much effect on the price of a top barrister is doubtful. The economics of the Bar are more like those of the pop music or football industries than those of a trade union closed shop. People pay vast sums for top lawyers' services, because it is worth a few hundred thousand to increase the chances of winning a case worth tens of millions. So top barristers will continue to earn indecent sums.

But the consequences may reach beyond the Bar. Lord Irvine's tactical retreat is likely to advance the argument for more fundamental reform. Though he strongly defends his right to be both head of the judiciary and a senior minister, his dual role looks increasingly anomalous. The Bar Council thinks that judges should be appointed by an independent commission. Lord Irvine himself spends less and less time sitting as a judge. He has sat on only one case in the past two years. By abolishing QCs, Lord Irvine may find that he has taken the first step towards splitting the political and judicial sides of his job.

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Scottish biotechnology

Dolly was a red herring

May 1st 2003 | EDINBURGH
From The Economist print edition

Scottish biotechnology is healthier now it is more boring

Get article background

THE birth six years ago of Dolly, the world's first cloned sheep, was a huge boost for the hitherto unknown Scottish biotechnology industry. Six years later, Dolly is dead, stuffed, and in a museum; and the company which is trying to make money out of the cloning technology, PPL Therapeutics, announced on April 28th that it was ditching plans for a £42m factory to turn out Dolly-based medicines.

PPL, spun out of Edinburgh's Roslin Institute, a government research centre that created Dolly, has raised £60m since 1998. Most was to pay for the development of new medicines for chronic lung diseases such as cystic fibrosis and emphysema, which can, in theory, be made from proteins in the milk of a cloned flock. Bayer, a big pharmaceutical firm, was sufficiently impressed to chip in £10m. Now, most of the money has gone, the medicines are still at least four years away and the firm's share price has plunged.

PPL's founders were blinded by the brilliance of their science and failed to produce something they could sell. New management installed last year has now binned the exciting science and is concentrating on making money. PPL's most promising product, a type of surgical glue, has nothing to do with cloning: it, and the lung disease treatments, will be made from the milk of transgenic sheep—animals bred in the normal way whose DNA has been altered by means available long before Dolly appeared.

The need to be boring is a lesson that many have learnt. “A few years ago, you raised cash from venture capitalists and investors drawn by sexy, glamorous science,” says Stephen Hammond, chief executive of Scottish Biomedical, a contract research firm. “That has pretty much dried up now. You need to get income and that comes from products.”

Despite investor scepticism about biotechnology, the Scottish sector is still growing. According to Scottish Enterprise, the number of biotech researchers is up from 2,500 in 1999 to about 8,000 now, while the number of companies has grown from 49 to 97. The few profitable firms make relatively routine products or do contract work for the big pharmaceutical companies. It is less glamorous than Dolly, but safer.

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Bagehot

The devolutionist's dilemma

May 1st 2003
From The Economist print edition

Localism is all the rage, but do people really want it?

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AS *The Economist* went to press, votes were being cast in local-government elections across England. But not very many: little more than a third of those entitled to vote will bother to do so. The surprising thing is not that turnout is so low, but that it should be so high when the outcome has so few consequences for people's lives.

This is something that politicians from all parties say they are very worried about. The Liberal Democrats have always wanted more power for local government because the councils they control are the nearest thing they have to a power base. But for Labour and the Conservatives, who, between them, have centralised government to a degree unknown elsewhere in the democratic world, it's quite a new concern.

These days, everybody is in favour of “localism”. The Tory local-government spokesman, Eric Pickles, cheerfully beats his breast over past errors: “We were absolutely wrong. We're born-again local.” A recently formed think-tank, the New Local Government Network, headed by a New Labour insider, Dan Corry, has been pushing with some success what it calls the “new localist” agenda. Even Tony Blair, no great fan of local government, has begun to remember the lines he used to spout before he became prime minister about local diversity and strong, empowered communities.

How seriously should one take all this? Despite some half-baked devolution on the Celtic fringe, Labour has done its best to stifle what little was left of local-government autonomy in England by means of thousands of centrally conceived targets and initiatives. After 18 years in frustrated opposition, the idea that local government might be anything more than a transmission mechanism for the “project” was never seriously considered.

Councils have found that even the things which they thought they might have some slight say over are determined from the centre. No home secretary has ever seized more direct power over policing than David Blunkett. Up to a million new homes are to be forced on the over-crowded south-east by John Prescott, deputy prime minister and minister for this sort of thing, in defiance of the wishes of local people and their representatives in the councils.

And then there is education—still, at least in theory, the biggest thing for which local government retains responsibility. The row between the government and local authorities about what has become known as the “missing £500m” encapsulates the problem. Last year, the government announced the largest increase in schools funding that a crude reading of the numbers would bear—about 6% for each of the next three years. But it has not worked out quite like that.

Under the fiendishly complex funding formula that provides at least 80% of local authorities' money, councils in some parts of the country—the better-off south-east, mostly—got only 3.2% more. From this, schools had to cover the costs of the higher national-insurance charges levied by Gordon Brown, the chancellor of the exchequer, to pay for the health service, and increased pension contributions. Many schools with falling rolls have had even less than that. The government blames some councils for not passing all the money they have been given to schools, while the councils blame the department of education for wasting money on pet schemes that are fun for bureaucrats, but not much use to children.

Unless you think that schools are best run from Whitehall, there are two possible solutions to this typical mess. Either the money central government provides should go straight to the schools (or, better still,

the parents) to spend as they see fit, or local authorities should raise far more of what they spend and account for it to local people.

A little local difficulty

The government understands the problem. It is now aware that its top-down approach to managing public services is flawed and that service-providers will not respond to local needs until they are locally accountable. But, as Tony Travers of the London School of Economics says, it is like a clever junkie: it knows what it should do, but it keeps on finding arguments for not doing anything just yet.

This is not, however, simply a problem of political will. There is a real dilemma, as shown by the bitter arguments now raging over the quasi-independent foundation hospitals. Deep within Labour's psyche is the notion, developed by the early Fabians, that the state should treat everyone the same, regardless of how much they earn or where they live. Nor is this preoccupation confined to the left. Tabloids of all colours deplore the idea of a “post-code lottery”. So the centralisation of local-government finance is not just a mechanism for political control, but also a way of ensuring that the standard of public services does not depend on the local tax base.

But equity comes at a price. Local government should hold sway over many of those things that people care most about. Yet it can't do so unless it raises much more of the money it spends. As things are, it is correctly perceived as little more than an agent of the state; local democracy is seen as a sham. The dead hand of centralism also kills the impetus to innovate and improve that characterised the thriving, competitive municipalism of England in the late 19th century and of America today. Whereas Liverpool has for more than 30 years depended on a life-support system fed from London, Detroit, in the absence of such a subsidy, has discovered the determination and the ideas to save itself from near-extinction.

There is a real choice to be made, and the new localists should admit it: does democracy, or a peculiarly British concept of fairness, matter most?

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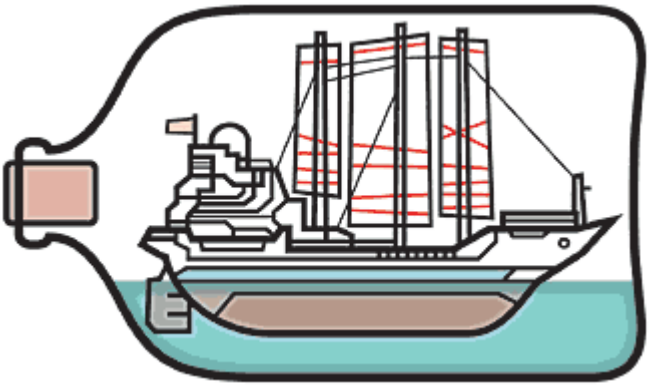
A cruel sea of capital

May 1st 2003
From The Economist print edition



Global financial integration is supposed to lift countries up. Sometimes it sinks them. A guide to safer sailing, by Clive Crook

THOSE who believe that globalisation throttles democracy, gouges the poor and fouls the environment are bound to regard today's mostly open markets for international capital as evil. However, this does not prove that unimpeded flows of capital are a good thing. The capital market has vindicated its critics and embarrassed its would-be defenders too often of late. It has been responsible for, or at least deeply implicated in, some very costly economic breakdowns. Perhaps the anti-globalists are on to something.

Rapid globalisation has done nothing to undermine the confidence liberals have always placed in trade. No serious economist questions the case for international integration through flows of goods and services, though there is a lively argument over how integration through trade can best be brought about. Trade is good. But even the most enthusiastic advocate of economic integration may be starting to wonder whether unimpeded flows of capital are quite such a blessing.

Economic principles suggest that they should be. Economics relies heavily on the idea that wider opportunities make people better off—or at least that they do not make them worse off. Whatever else trade does, it widens opportunities. When trade barriers come down, people on each side have an opportunity lacking in a closed economy. They can decide to consume goods that they have not produced, and pay for them by producing goods they do not wish to consume. If they believe they are better off as a result, that is what they will do. Otherwise, they will carry on as before.

Essentially the same logic applies to international finance. Just as a closed economy can consume only what it produces, it can invest only what it saves—no more, no less. Trade in capital makes it possible for countries to separate their saving and investment choices. They can invest more than they save by borrowing the difference from abroad; or they can invest less than they save by lending out the surplus. Changes in the price of capital will ensure that global supply and demand match up, just as changes in the prices of goods bring exports and imports into global balance.

Just as nothing forces a country to trade when the economy opens up, nothing forces a country to become a net importer or exporter of capital if its firms and individuals prefer to lend and borrow as they did before. International capital widens choices in just the same way as international trade.

So how can you be worse off if you are given choices you did not have before, without being obliged to take them up? The answer is that you may make choices you come to regret. Experience suggests that even within the borders of a single economy, trade in capital is far more prone to mistakes than trade in goods or services—though why this should be so is not immediately obvious. And if domestic trade in capital is more error-prone than domestic trade in goods, then international trade in capital is even worse. This perhaps is easier to understand: take the mistakes that get made in a domestic context, then

multiply them by ignorance due to distance and exchange-rate risk.

The result is plain enough: recurring financial calamity; sovereign debt default; capital flight; currency crisis; bank failure; stockmarket crash. And the harm is by no means confined to the people who made the mistakes, or to the finance industry at large. Financial collapses have an unmatched capacity for projecting their effects right across the domestic economy, and in the worst cases far beyond that, across the region and even across the world.

Even if there were no doubt that the gains from trade in capital are large—on a par with the gains from trade in goods and services—the costs incurred in recent financial emergencies would still give one pause. Financial crises of the sort that hit Latin America in the 1980s, Mexico in 1994 or East Asia in 1997-98 cause recessions equivalent to years of growth forgone. The 1980s were aptly called Latin America's “lost decade”. Argentina and Brazil, to name but two, are even now struggling, respectively, with an exceptionally severe recession and the threat of a new financial collapse. Financial distress is a salient ingredient in Japan's endless economic difficulties, in Europe's current slowdown, in the fragility of America's economic recovery. And if things grow suddenly worse in any of these places, finance will spread the damage far and wide.

Even within the borders of a single economy, trade in capital is far more prone to mistakes than trade in goods or services

So trade in capital is different from trade in goods and services in two main ways: in the scope for getting things wrong, and in the punishment that follows. The first is great and the second is fearsome. It is enough to make a good liberal stop and think.

We all make mistakes

What makes finance so prone to error? Financial markets are asset markets: that is, they are markets for streams of payments spread out over time. (Many goods and some services have an extended time dimension too. By definition, the more this is true, the more such goods and services behave like assets. That is why the market for houses behaves a lot like the market for corporate bonds and not much like the market for biscuits.) When you buy an asset you are gambling on the future. Small changes in beliefs about the future can have a surprisingly large effect on the value of the assets concerned.

The numbers can seem outlandish, but it is only a matter of the arithmetical relationship between present value, compound interest and future value. Pricing a company share, for instance, involves several variables, but on plausible assumptions an improvement of just one percentage point in the expected growth of a company's earnings could easily justify a rise of 25% in its share price.

In other words, because asset prices are bets on a distant and uncertain future, they are inherently volatile. Moreover, investors tend to deal with uncertainty in ways that aggravate the problem. If information about underlying value is absent or obscure, they are likely to become preoccupied with the views of other investors. Sometimes, maybe usually, this is a process that uncovers new information and disperses it. Now and then, however, it degenerates into crowd hysteria.

When you buy an asset you are gambling on the future. Small changes in beliefs about the future can have a surprisingly large effect on the value of the assets concerned

In extreme cases, the views of other investors are taken seriously even when flatly contradicted by such facts as may be available. That was certainly true during the later stages of the dotcom bubble of the 1990s, and there are countless other examples. From time to time, such mental aberrations are even dignified by being presented as “schools of thought”: from “momentum investing” and “greater fool theory” to “the new economy”.

Now add to this the possibility of leverage. Thanks to capital markets, investors can place their bets on this distant and uncertain future using borrowed money. Without debt, the most you can lose is everything you have. If you can borrow, on the other hand, there is really no limit to what you can lose, because leverage allows you to punt other people's money as well as your own. Financial markets attract talented and ingenious people. A great deal of effort, it is said, goes into finding ways of pooling and reducing risk. Evidently, however, a good deal also goes into finding ever more complicated ways of building leverage on leverage, and then leveraging some more.

It has been widely noticed that going bankrupt for a few million dollars is no more painful than going

bankrupt for a few thousand. This is apt to discourage prudence, and the imprudent, however talented and ingenious, make mistakes.

Debts are also a main reason why mistakes in financial markets, when they happen, can have bigger consequences than errors in an economy's less excitable parts. Losses may cascade across a series of lenders, many of which may not even have realised that they were exposed to the risk. A surprise that is big enough and bad enough may perturb the mood of self-justifying expectations that had up to then been propping valuations across an entire class of investments, and at worst across the economy as a whole.

A particular risk is that a bank may be threatened with failure as a result of its losses. Banks are intrinsically fragile entities, which is why, historically, they have invested so much in the pretence of security and solidity. They promise to give depositors all their money back on demand. As soon as depositors ask a bank to make good on that pledge, the bank (which retains only a fraction of its deposits in ready cash) goes bust. Depositors at other banks may then want their money back too. And because banks provide the infrastructure of payments services in a modern economy, that comes under threat as well.

Banks are intrinsically fragile entities, which is why, historically, they have invested so much in the pretence of security and solidity

Financial volatility need not in itself be such a bad thing. Even if it causes volatility in GDP, and hence in incomes, that is not necessarily disastrous either. People have ways of protecting themselves against ups and down in their incomes. Financial markets, of course, can help them in this. Governments can help as well, with safety-nets of one sort or another and with policies that mitigate the highs and lows of the economic cycle. Unfortunately, the evidence suggests that financial volatility not only causes bigger ups and downs in output and incomes, it also leads to lower average incomes over time. Latin America's lost decade really was lost.

All this, to be sure, could perfectly well be true of a closed economy. But an economy with financial links to the outside world may, according to circumstances, face much bigger risks. The problems of uncertainty are worse, for the reason already mentioned: distance, measured not just in miles but also in differences in language, business culture and legal environment. This increases the tendency to rely on other investors' judgments rather than one's own. It also increases the scope for risk that is disguised, accidentally or otherwise, and hence the danger that investors will be taken by surprise.

And trading capital across borders usually involves an additional financial market that is especially susceptible to all of the above: the market for foreign exchange. Most if not all of the big financial crises of recent decades have involved banking crises, currency crises or both. In these ways, the global capital market appears to take a big problem—the economic instability that would anyway be caused by purely domestic finance—and make it worse.

If the scope for error in capital markets is so great and the subsequent punishment so brutal, do the benefits of unimpeded global finance, substantial as they may be, justify the risk? The answer, as this survey will argue, is yes—but for many economies it is a close thing. Much depends, as well, on exactly what is meant by “unimpeded”.

A close-run thing

Trade in goods and services is simple: what governments need to do, through the World Trade Organisation, through this or that regional trade agreement, or best of all unilaterally, is abolish their barriers. When it comes to finance, there is no such straightforward advice. “Let capital flow where it may” is bad policy. Finance must be intelligently regulated, at home as well as internationally, in ways that ordinary commerce does not require. When capital flows are liberalised, it needs to be done cautiously and within prudent limits. To that extent, global finance must indeed be impeded.

Governments and their advisers are a long way from understanding how this should ideally be done, let alone from putting any such understanding into practice. There is no detailed consensus on the right approach to international financial regulation, any more than there is on the domestic sort: there is plenty of activity, but for the most part it is co-operation without conviction.

The risks of international finance need to be frankly acknowledged, and then reduced so far as possible. That means weighing the costs and benefits of different kinds of capital mobility, and setting policies

accordingly. It means abandoning certain orthodoxies of international economic policy. The danger cannot be eliminated altogether, but the remaining risk is worth taking because the potential gains from international capital flows are large, especially for the world's poor countries.

To ignore that potential would be an even greater mistake than to liberalise recklessly. The global capital market is a treacherous aid to economic growth, but in the end, above all for the poor, an indispensable one.

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Catching the tide

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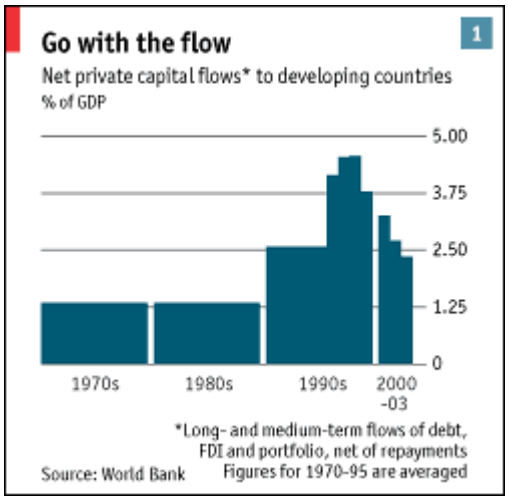
Why does so little capital flow from rich countries to poor?

SUPPOSE capital were bottled up in individual countries, not free to flow from one to another. Rich economies would have lots of it. Too much, in a way: the law of diminishing returns would have set in. Poor economies, in contrast, would have less capital than they can put to good use: returns to extra capital there would be higher. Both kinds of country, and the world as a whole, would be better off if people were free to move capital from the one to the other—or so it would seem.



The poor-country capital importers would invest more and produce more. The rich-country capital exporters would invest less, but the income they lost this way would be more than outweighed by the additional income they received from investments abroad offering high returns.

This is the simple theory of international capital flows. Sometimes it works. For sustained periods during the past century or two, capital went where it was supposed to, and made a great difference to the pattern of economic development. In the last quarter of the 19th century, British capital equivalent to 5% of host-country GDP and more flowed out each year to the United States, Canada, Australia and Argentina. France and Germany were big exporters of capital too, though not quite on that scale. The flows paid for a large part of the investment undertaken in the capital-importing countries.

This golden age of financial globalisation ended in 1914. Global financial connections were cut by the first world war, and only briefly repaired in the immediate aftermath. Then, for nearly half a century, from the Depression until the 1970s, international flows of private capital dwindled to almost nothing. In the 1970s, net flows of private capital to the world's poor countries amounted to a little over 1% of host-country GDP. This trickle was sufficient to finance a miserly one-twentieth of what many poor countries spend on investment (and an even smaller share of what they should be spending).

By the end of the 1970s, those meagre figures were increasing, though they still fell far short of the 19th-century boom. And the resurgence, such as it was, ended badly, in the debt crises of the 1980s. By the end of the 1990s, flows had recovered from that setback and endured two more—the Mexican devaluation of 1994 and the East Asian debacle of 1997-98. Taking one decade with another, flows in the 1980s were about equal to flows in the 1970s; during the 1990s, they were substantially larger. By the end of the 1990s, annual flows as a proportion of developing-country GDP were some three times bigger than in the 1970s (see chart 1).

Nonetheless, measured against the apparent opportunities for productive investment in the developing countries, as well as against the flows a century earlier, they were still small. At the end of 2001 (the latest year for which figures are available) the worldwide stock of cross-border bank loans and deposits was $9 trillion. Of that, only around $700 billion was attributable to developing-country borrowers. The stock of global cross-border investment in securities was some $12 trillion, of which developing-country borrowers accounted for just $600 billion. As in the 19th century, moreover, most of the capital exported by rich countries to poor countries still travels to just a handful of recipients.

Anti-gravity

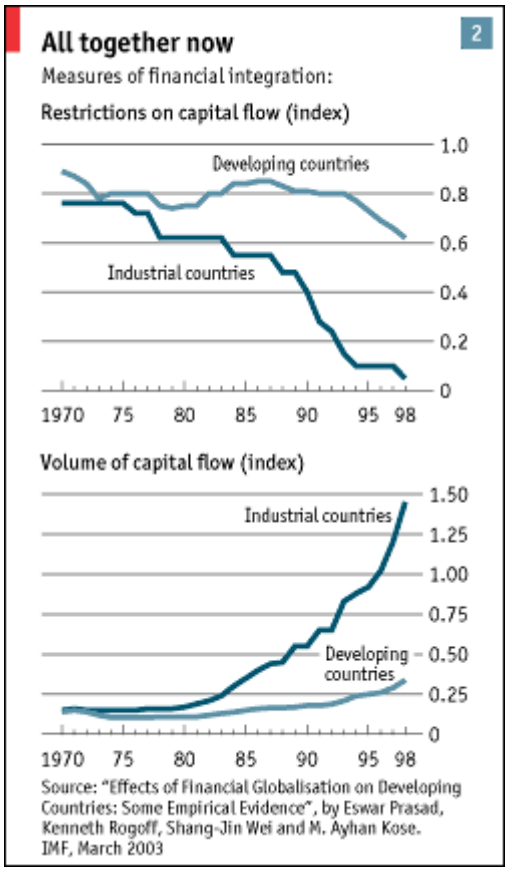
These figures belie the idea of a steady tide of capital running from rich countries to poor. On average, it is true, creditor countries are richer than debtor countries; in this sense, at least, capital does flow

downwards. But there are some notable exceptions even to this broad pattern. Despite its economic slowdown, the United States continues to invest a lot while saving next to nothing: its economy draws in huge amounts of capital from abroad, and its net foreign liabilities currently stand at more than 20% of GDP.

All this raises a question. The most successful developing countries of an earlier era showed that foreign capital can make an enormous difference to their prospects for rapid development. Financial crises notwithstanding, rich-country investors profited too. Why, in that case, does capital today not flow in much larger quantities from rich parts of the world to poor?

One reason is that capital is not the only thing which is lacking in most developing countries. Labour may be plentiful, but workers in poor countries are mostly less well educated and have less training in industrial skills than their rich-country counterparts. In many countries, property rights are insecure and the rule of law is unreliable. The economic infrastructure necessary to get the most out of new investment may not be there. Political risk may be a problem. For these and other reasons, switching capital from countries where there is plenty to countries where there appears to be a shortage yields smaller profits than one would suppose. (America's overwhelming advantages in all these respects help to explain why it attracts so much new capital, despite seeming to have more than it needs.)

Second, most developing countries do not let capital come and go freely. Blanket restrictions on the movement of capital are much rarer than they used to be, but assorted official or unofficial obstacles are still often put in the way of foreign investors. Despite measures to liberalise the capital markets in recent years, they are still far less open to cross-border finance than the typical developed economy (see chart 2).



So where the flow of international capital could do most good—in the developing countries—there is precious little of it. Does that matter? If you take the view that capital flows are more of a curse than a blessing, probably not. Yet history suggests that the most successful developing countries, at least up until the first world war, benefited enormously from foreign capital. And everybody agrees that the flow of capital from one rich country to another is wholly beneficial for both sides. Is anybody suggesting capital controls for the United States? Not even those who consider America's present rate of capital inflow worryingly high. The benefits of access to global capital markets are called into question only for poor countries.

To get an idea of what is at stake, it would be useful to have a rough estimate of the developing countries' gains from capital flows. Unfortunately, no generally agreed estimates exist. The 19th century seems too remote a guide. Careful analysis of the more recent connection, if any, between capital flows and growth in developing countries is still surprisingly sparse, though interest in the subject has been mounting lately. As yet there are relatively few studies, far fewer than of the links between growth and trade, and the results have not settled down to anything resembling a consensus. This is partly because the expansion of rich-to-poor capital flows to significant size is, as noted earlier, a comparatively recent event.

Guessing the benefits

Two other things frustrate efforts to estimate the gains. One is that the main effects of openness to capital can be expected to push in opposing directions: access to capital ought to spur investment and growth, but at the same time it will expose an economy to additional economic turbulence which may slow it down. The net result will be difficult to uncover among all the other factors contending for influence.

Also, “capital flows” is a broad term. It includes quite different kinds of financial transaction: bank lending, short- and long-term; investment in public or private bonds; investment in equities; direct investment in productive capacity. Each has different implications for growth on one hand and exposure

to capital-market risk on the other. The gains from capital inflows are going to depend on exactly what kind of capital is flowing. Again, statistical evidence may struggle to provide answers.

Still, one may hazard a guess. According to one recent review of the literature, by Wendy Dobson of the University of Toronto and Gary Hufbauer of the Institute for International Economics, developing countries may have gained roughly as much, overall, from access to global capital markets as from access to trade in goods and services. The authors say it is plausible to suppose that by 2000 developing countries were gaining around $350 billion a year in additional GDP thanks to access to the global market in goods and services. As a result, developing-country GDP was about 5% higher than it would otherwise have been. Drawing on research that aims to separate the effects of different kinds of capital, they calculate that the gain up to now from even the limited access to international capital these countries have enjoyed might be about the same.

If the gains from (incomplete) capital-market integration really are as big as that, they would be worth the price of a financial crisis or two. Over the past few decades, admittedly, the world has suffered more than a few. When it did the sums in 1999, the IMF counted 64 banking crises and 79 currency crises since 1970. (That includes some double-counting, because many countries had both kinds of crisis simultaneously.) Most of these were small affairs, national rather than international in character. Over time, however, the role of international capital in spreading financial breakdown across borders has been growing. And when financial crises happen, the toll on incomes is heavy.

Ms Dobson and Mr Hufbauer have gathered estimates of the cost in lost GDP of 24 banking crises and 36 currency crises during the 1980s and 1990s. Research suggests that the calamities of the 1980s cost Latin America an average of 2.2% of GDP a year over the decade. In the 1990s East Asia's financial traumas cost the region 1.4% of GDP a year.

Within these regional averages, of course, some countries suffered much more than others. Indonesia's output, for example, fell by 14% in 1998 alone, against an earlier trend of 7% annual growth: a one-year GDP shortfall of more than 20%. Overall, though, the cost of financial crises for all emerging-market economies worked out at around 0.6% of GDP a year for the 1980s and 0.7% of GDP a year for the 1990s (see table 3). Set beside Ms Dobson's and Mr Hufbauer's estimated capital-market benefits of 5% of GDP a year, that does not seem too bad.

Downside 3

GDP losses from banking and currency crises

	1980s	1990s
GDP loss from financial crises in emerging markets, $bn	249	419
Asia	13	260
Latin America	207	123
Africa	15	18
Europe	na	11
Middle East	14	7
Average annual GDP loss in emerging markets, %	0.6	0.7
Asia	0.1	1.4
Latin America	2.2	0.7
Africa	0.5	0.6
Europe	na	0.1
Middle East	0.3	0.1

Source: "World Capital Markets: Challenge to the G10", by Wendy Dobson and Gary Clyde Hufbauer. Institute for International Economics

However, many critics of financial globalisation would challenge these numbers, especially so far as the benefits are concerned. And they have a surprising new ally. A new review of the empirical literature by economists at the IMF, traditionally devoted to the cause of open capital markets, finds no consensus that financial integration yields any net benefits in growth at all (even though, the Fund insists, in theory it ought to). Of 14 papers reviewed, only three find that financial integration has a positive effect; another four find that the effects are mixed; and the rest find no effect one way or the other. The IMF's review also looks at the relationship between other measures of economic well-being and different measures of economic openness. Trade improves economic welfare, according to this research. Financial integration has no significant effect.

The absence of a clear conclusion suggests two possibilities. One is that financial integration is indeed a mixed blessing: it has costs as well as benefits, making net benefits (if any) hard to spot. Second, unlike free trade, financial integration may be good for economies only if certain conditions are met. If countries meet these requirements, they gain; if not, they lose. On balance, the effects tend to cancel out. These theories are not mutually exclusive.

Split the difference

Even so, for some countries, at least, access to global capital is likely to bring advantages as well as drawbacks. And there is no need to come to an all-or-nothing judgment about capital flows. The choice is not between completely unfettered flows and financial isolation. According to circumstances, a middle

way may be best. The aim should be to reduce the costs of financial integration without casting aside such benefits as there may be.

Seeking the benefits of financial integration while suffering fewer costs is a difficult task, as the rest of this survey will explain, but by no means a hopeless one. There is little prospect of ever eliminating the risk of financial crisis, short of eliminating finance itself. But the terms of the trade-off between higher incomes (because of broadened economic opportunities) and higher risk (because of exposure to financial hazards) can be improved.

Unfortunately, developing countries face particular difficulties in striking the right balance. The combination of malfunctioning domestic finance, weak regulation and erratic economic policy is perfectly designed to get the worst out of financial openness. In countries where those failures are severe and cannot be corrected, an incautious opening of the economy to foreign capital is likely to do much more harm than good.

Reaching a modest minimum competence in regulation and economic policy is crucial for the emerging-market economies. And there is a lot of work for governments elsewhere too—very much in their own interests, not just for the sake of spurring development in the poor countries. Rich-country suppliers of finance, rich-country regulators and the international financial institutions directed by rich-country governments all need to do better if the full mutual benefits of financial globalisation are to be achieved.

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Hot and cold running money

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From The Economist print edition

One way of increasing the benefits of global capital while reducing the costs is to alter the mix

ARE some kinds of capital inflow better than others? On the face of it, yes. Borrowing from a bank, for example, is relatively risky. If, for example, the borrower's income falls, for whatever reason, he has no choice but to service the debt just as before, even though his capacity to do so may be less. A bank loan taken out at a floating interest rate, or denominated in foreign currency, exposes the borrower to additional risks beyond his control. Banks may call in loans, or refuse to roll over short-term credits.

At the other extreme, foreign direct investment (FDI) looks comparatively safe. In effect, the foreign investor is sharing much of the receiving country's risk. If profits should fall, so will the foreign investor's income from his investment: the cost of servicing the investment moves in step with the recipient's economic fortunes. Also, FDI is a lot more difficult to withdraw when times are hard. Investments may have to be sold at a loss, if they can be sold at all. Somewhere between bank loans and FDI in terms of risk-sharing are portfolio investments such as bonds and shares.

Again, however, there are trade-offs which make the choice more complicated than it seems. A key issue is cost: there is no something for nothing in international finance. FDI may be a safer source of capital than borrowing from a bank, but in the long run it is likely to be more expensive. The reason is simple: in return for shouldering extra risk, investors require a bigger income. In the end, the share of profits to which FDI entitles them can be expected to pay a lot more than the interest payments due on a comparable bank loan.

FDI has other drawbacks. It is much more difficult to arrange. Banks specialise in bridging the gap between investors and borrowers, bringing them together even though one may know nothing about the other. FDI demotes the middle-man to an advisory role at most, so the principals have more to do. Direct investment requires a close long-term relationship between the investor and the company that is invested in.

This is an advantage in some ways. FDI often brings the recipient useful technical and managerial knowledge, and vital contacts in world markets, as well as money. But an FDI partnership requires a big investment of time and effort, especially on the investor's side. This will tend to narrow the scope of FDI to large projects in relatively large recipient countries (which can offer the investor a correspondingly big market for its output). Of all the companies or activities in developing countries that could make good use of foreign capital, comparatively few are currently in a position to attract FDI.

A pity, because the economic evidence, such as it is, seems to confirm that FDI is on balance the most desirable form of capital inflow. Recall the estimate quoted earlier for the developing countries' gains to date from openness to cross-border capital: an improvement of 5% in GDP, roughly on a par with the gains from trade. The studies which yield that number allow separate (albeit rough) estimates to be made for the respective gains from FDI, portfolio flows (bonds and equities) and bank loans. This research suggests that a rise of one percentage point in the ratio of the stock of FDI to GDP will raise

GDP by 0.4%. In the decade to 2000, the ratio of FDI to GDP in the developing countries went up from 7% to 21%. That rise of 14 percentage points implies an improvement in GDP of 5.6%.

The evidence on whether portfolio investment affects growth is even more sparse than the evidence on FDI. However, the OECD's Marcelo Soto, whose work was used in deriving the FDI estimate, has looked at both. He found that, within the total of portfolio flows, equity flows have an even bigger positive effect on GDP than FDI, an admittedly strange result. Conversely, bond flows actually have a negative effect. Averaging the two, with a 60% weighting for bonds (to reflect the mix within the portfolio-flows total), suggests an improvement of 0.2% in GDP for each one- point rise in the ratio of portfolio capital to GDP. Between 1990 and 2000, the ratio of portfolio capital to GDP in the developing countries rose from 8% to 14%, implying an improvement in GDP of 1.2%.

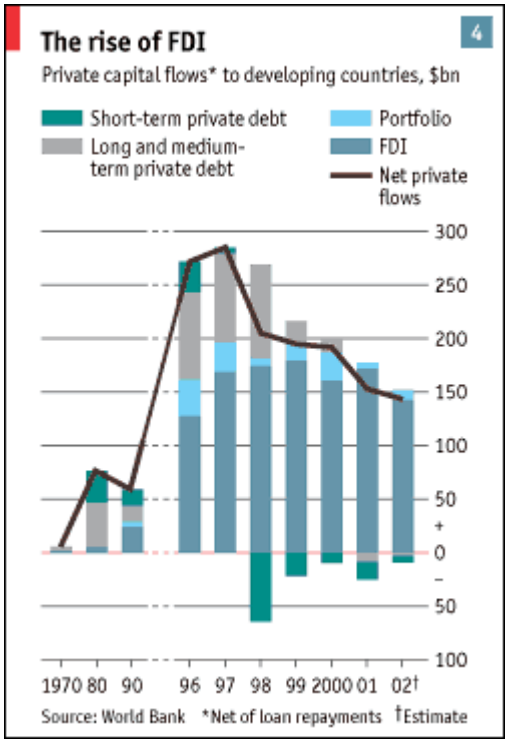
According to the same research, bank debt is the one to avoid. It is estimated to reduce GDP by between 0.2% (Mr Soto's figure for loans) and 0.4% (trade-related credits) for every rise of one point in the ratio of bank debt to GDP. The developing countries' stock of foreign bank loans and trade credits increased from 30% of GDP in 1990 to 37% in 2000. That implies a fall in GDP of around 2%.

It just so happens

At best, these figures should be regarded as only a rough guide to orders of magnitude. Nonetheless, they seem to support a preference for FDI over portfolio flows, and a strong preference for either of these over bank-debt flows.

Recent years have seen a dramatic shift in the composition of capital flows to the emerging-market economies. In light of the evidence on the advantages of different kinds of capital, the change looks like one for the better. Bank lending has fallen sharply. Portfolio investment (bonds and equities) has gone up. And FDI has soared, despite the difficulties in expanding it as quickly as many countries would wish.

In 1980, flows of short-term debt to emerging-market economies amounted to $30 billion, net of repayments. In 1990, the figure was $15 billion. From 1998, flows of short-term debt turned negative; that is, repayments and interest exceeded new loans. FDI inflows moved sharply in the opposite direction: from $5 billion in 1980 to $24 billion in 1990 and $160 billion in 2000. Net portfolio investment has increased too, from about zero in 1980 to $26 billion in 2000 (see chart 4).



A variety of factors lie behind this changing pattern. Bitter experience, culminating in the East Asian debacle, has curbed the banks' own appetite for conventional cross-border lending, though perhaps only temporarily. Attitudes have also changed in many of the developing countries. In some of them, financial liberalisation has opened domestic securities markets to foreigners for the first time. In others, access may not yet be free but is at least easier than before. And attitudes to inward direct investment have undergone a transformation. Even countries such as India, which for decades set its face against foreign ownership of local assets, are vying with each other to draw foreign investors in. China's remarkable growth during recent years, fuelled in part by its success in attracting FDI, has not gone unnoticed.

Even if economic policy in industrial and emerging-market countries did nothing further to alter the mix, the trend towards greater flows of FDI and equity finance seems likely to continue. This is not because the lessons from the financial crises of the 1990s have been taken to heart: financial markets have short memories. It is because economic development itself seems to favour this kind of finance.

As the developing countries become more prosperous, their financial and legal systems will become more sophisticated. FDI opportunities will become easier to find and exploit, and domestic financial markets will converge on the standards of depth and organisation familiar in the rich West. As domestic banking systems mature, moreover, they will be able to meet more of the financial needs so far satisfied by bank borrowing across borders. With economic growth and intensifying globalisation, every kind of financial

flow might well continue to expand. But the mix of capital types, left to itself, is likely to drift gradually in the right direction.

Faster, faster

Ought governments to be satisfied with that, or should they try to accelerate this recent trend? The answer is that they should hurry it up. Some suggestions follow as to how they might do it. But first a word of caution: intervention of this kind needs to be done rather carefully.

If different kinds of capital were a close substitute for one another, there would be little need to hesitate in trying to improve the mix. Policy could aim to reduce cross-border bank flows and increase FDI, say; the expanded FDI would meet all the needs satisfied up to now by cross-border bank finance; capital flows would be safer, and nobody (except the banks) would be any the worse off. The trouble is that different kinds of capital cannot stand in for each other in this way. Many of the borrowers in developing countries that could put foreign capital to good use lack access to FDI, or to equity finance for that matter, and will for the foreseeable future. A strong push against cross-border bank debt could leave most such borrowers stranded. Risky capital from banks may be the only kind they can get.

This danger will be especially great in the poorest, worst-governed countries. Recall that FDI and cross-border equity finance are safer for the borrowing country because the investor shoulders more of the financial risk. In backward countries, foreign investors may simply refuse to do that. Legal systems may offer little or no protection against breach of contract, expropriation or outright theft. Corruption too is often an issue. In such circumstances, a western company with a reputation to lose will think twice before entering into a close economic partnership. To be sure, bank lending to such countries is hardly to be recommended either—but it may be that or nothing. Ruling out bank lending altogether is going to make some worthy borrowers worse off.

All or nothing?

Another risk is that in trying too hard to discourage one kind of capital, governments may inadvertently discourage others too. Maybe cross-border bank finance goes hand in hand with cross-border equity finance and with FDI. Discourage the banks, and far from seeing FDI and equity finance rise, you may see them fall, again leaving the borrowing countries worse off.

On the whole, though, the evidence on these interconnections is encouraging. It certainly does not seem to rule out cautious efforts at reforms to improve the mix. Within domestic financial systems, different aspects of financial development tend to go forward together. Bank finance and stockmarket development, for instance, seem to be closely associated. But there is little sign that cross-border bank finance has any particular significance in this. Certainly, economic policy needs to nurture efficient domestic banking: for its own sake, and also because otherwise equity markets and other aspects of financial deepening may be held back. But so long as governments do not discourage cross-border bank finance in a way that also discourages domestic bank finance, the effects on FDI and securities markets are likely to be slight.

One risk is that in trying too hard to discourage one kind of capital, governments may inadvertently discourage others too

So far as substitution of one kind of capital for another is concerned, the price to be paid for discouraging cross-border bank lending seems affordable. Other forms of capital are unlikely to expand to fill all of the gap, but they will expand to fill most of it—especially if the rules are drawn up to discourage only those forms of bank finance that are particularly hazardous for poor-country borrowers.

If the rules concentrate on discouraging short-term lending, for instance, the resulting gap can be filled not just by additional FDI and portfolio investment, but also by additional long-term loans—not as risky as short-term loans. In 1991 Chile imposed an implicit tax on inflows of short-term capital to reduce the aggregate inflow. In that, the policy failed: the overall flow was not much changed. But studies conclude that the tax did alter the pattern of inflows, shifting it away from short-term debt. That was a useful, albeit accidental, discovery.

Bear in mind, also, that in making the global capital market a safer place, the policy-reform agenda goes far beyond the extent to which developing countries should encourage or discourage particular sorts of

inflow. It requires changes in a broader set of policies, aimed at promoting an efficient and well-balanced domestic financial system. That in itself will help speed the right kind of inflows; and without it, even the right kind of inflows would be little use.

Rich-country policies need to be looked at as well. The mistakes that led to the financial crises of the 1980s and 1990s were made by rich-country financial institutions under the supervision of rich-country regulators. And finally there is the multinational dimension: rich countries and poor countries alike need to examine the “architecture” of international finance, and see what kind of additional work—extensions, embellishments or strengthened foundations—may be needed. Are multinational bodies such as the IMF doing all they can to prevent crises or, if they happen, to manage them competently?

The financial upsets of the past two decades, and especially the East Asian crisis of the late 1990s, have yielded a mass of new information and spurred a great deal of activity under each of these headings. Under its own steam, the global capital market seems to have been moving lately to a safer and more productive mode of operation. Here and there, better policy can help to move that process along.

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The trouble with banks

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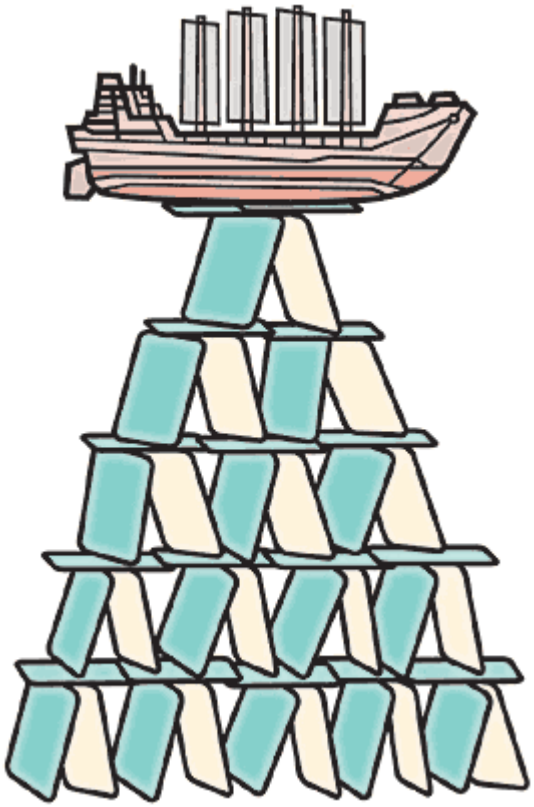
From The Economist print edition



Nobody loves them, everybody needs them

BANKS have proved themselves to be the most hazardous economic institutions known to man. Breakdowns in banking lie at the centre of most financial crises. And banks are unusually effective at spreading financial distress, once it starts, from one place to another. It it tempting to conclude that banks should simply be abolished. Unfortunately, that is unlikely to be possible. Banks seem to be necessary.

To see why, consider the job that any financial system has to do. It has to bring willing lenders and willing borrowers together. One way or another, this involves processing information. Two kinds of problem arise. First, the lender needs to know whether a would-be borrower is a good risk. To complicate matters, the keener the borrower—and the higher the interest rate he is willing to pay on the loan—the more likely he is to be a bad risk. This is called adverse selection: the most eager borrowers will be the least desirable, making lenders less willing to lend. The possibility of adverse selection inhibits productive lending and borrowing.

The other problem that financial systems encounter in processing information is moral hazard. Once a borrower has his loan, he may try to cheat. In investing the money, the most he can lose is the amount of the loan. But he may calculate that the greater the risk he takes with the money, the higher his chances of doing very well. Because his losses are capped, he is encouraged to take a bigger risk with his investment than he otherwise would.

Moral hazard becomes acute if the borrower expects to lose the value of his investment anyway. In that case he has nothing further to lose by taking a much bigger risk in the hope of turning his fortunes around. If this “gamble on redemption” works, he keeps all the proceeds after the loan is repaid, but the lender gets no extra return. If the gamble fails, the borrower is no worse off than if he had acted

prudently. Moral hazard also takes more obvious forms: some borrowers will be tempted simply to steal the money, or waste it, or otherwise do things that make it less likely that the lender will be repaid. Lenders deal with moral hazard in the same way they deal with adverse selection—by lending less than if they had all the information they needed.

This is where banks come in. They are specialists in dealing with adverse selection and moral hazard, which is why their role in financial systems everywhere is so central. They develop expertise in knowing what questions to ask borrowers seeking loans; indeed, they will already know a good deal about them if the would-be borrowers are existing customers. This allows them to screen out many of the bad risks. Access to information also makes it possible to curb moral hazard. Banks can monitor what their borrowers are up to; they can set restrictions on what the money is to be used for, and enforce them by threatening to call in loans or withhold new ones.

Could all this not be done by financial markets, at arm's length? Up to a point, but banks do have the edge. They are more likely to know a lot about the borrower to begin with. Moreover, they keep all the benefits of effective appraisal and monitoring to themselves, so they are willing to bear the risk.

Compare this with a loan that takes the form of a bond purchase. Suppose that one investor has managed to gather the information needed to curb adverse selection and moral hazard, and on that basis buys a bond from the would-be borrower. Other lenders will be able to see this public transaction taking place, and will be able to buy bonds too, profiting from the first investor's outlay on appraisal and monitoring at no cost to themselves. Because of this open invitation to free-riding, a market-based investor will not want to spend much on appraisal and monitoring: unlike the bank lender, whose transactions are private, he cannot keep the benefits to himself. Everybody will try to take advantage of everybody else's efforts.

As a result, there will be too little appraisal and monitoring, and the problems of adverse selection and moral hazard will be much less well controlled. The cost of lending is driven up; financial activity, and output and incomes in the wider economy, will all be lower. This is why banks are necessary.

Make that “banks”

Banks may be necessary because of their core financial functions, but just how widely the business of banking ought to be spread is more debatable. Some economies' financial systems rely on bank finance far more than others. And the nature of banking is changing fast almost everywhere. A core of traditional banking—deposit-taking and straightforward commercial lending—may be indispensable, but how much of it does a successful economy need? In many countries, traditional banking represents a diminishing part of what modern banks do.

Economists have long theorised about the relative merits of bank-based finance and market-based finance. For years it was taken for granted that financial systems dominated by banks, such as Germany's and Japan's, were better at mobilising capital and channelling it to the best uses than systems such as the United States' and Britain's, which give financial markets a larger role. This was especially true, it was believed, of economies at an early stage of development, where the information-gathering advantages of banks were crucially important. Believers in market-based systems emphasised the advantages on the other side, including improvements in the governance of companies fostered by an active market in corporate control.

By the end of the 1990s these supposed advantages of bank-based systems seemed rather less compelling. Japan (especially) and Germany were achieving a less-than-stellar economic performance, in stark contrast to America's remarkable success during the decade. The current economic consensus, underpinned by new research, is not that one system is necessarily better than the other, but that either can work fine so long as certain conditions are met.

The critical factor turns out to be the efficiency of the domestic legal system. If that is working well, a financial system can deliver the necessary array of financial services regardless of whether it is based mainly on banks or mainly on markets. Moreover, the evidence confirms that financial development—measured by the breadth of financial services, again regardless of whether they are delivered by banks or markets—plainly promotes economic growth.

The critical factor turns out to be the efficiency of the domestic legal system

So the modern findings on financial structure, even though they have retreated from the earlier idea that

bank-based systems work best, offer no reason to jump to the opposite conclusion. Get the legal fundamentals right, and banks are generally no better or worse than markets in allocating capital and promoting growth.

In any case, financial innovation is eroding the distinction. Over the past 20 years, deregulation, competition and technological progress have transformed banking worldwide. In a sense, banks have become increasingly market-based in the way they conduct their own business. The models are converging. Nowadays banks bundle assets (loans) into securities and trade them; increasingly, they earn income from fees as well as from interest. The once-sharp distinctions between commercial and investment banking, portfolio management and insurance are blurring. And the use of financial derivatives—in yet another new set of financial markets—is altering the way banks manage risk.

These trends are welcome in some respects and worrying in others. Banks can achieve a much finer degree of control over financial risk than before. In principle, this should improve the terms of the trade-off between risk and return across the entire economy, making it possible for an investor to achieve a given return at lower risk, or to earn a higher return for assuming the same risk as before.

But there are two snags. One is the sheer complexity of the positions that modern financial derivatives allow banks to create. Often, according to practitioners themselves, this outruns the ability of the institutions concerned to manage their risks. The other problem is much deeper. Sophisticated derivatives ought to help the economy find a better balance of risk and return, with the risks more accurately allocated to those who are willing and able to bear them. But what if banks are somehow predisposed to take on more risk than they should? Innovations that allow banks to gamble bigger sums would then appear in quite a different light.

This is exactly what modern financial instruments do allow. Leverage—increasing the likely gain or loss from an investment of a given size—is the salient feature of many derivatives. Buying an option to acquire shares in a company, for instance, is equivalent to buying a larger number of actual shares using borrowed money. Selling such an option can expose the seller to potentially unlimited losses. An increasingly bewildering array of complex derivatives make it possible to create enormous leverage. If banks for some reason tend to take on more risk than they should, financial innovation has unquestionably made this easier to arrange—and harder for supervisors, or even the bank's own managers, to monitor.

Unfortunately, banks do have a reason to take on more risk than they should. The reason, paradoxically, is the safety net that governments put in place to prevent bank failures. By trying to make banks safer, governments give banks the means and the motive to behave recklessly.

By trying to make banks safer, governments give banks the means and the motive to behave recklessly

Fond of a flutter

Banks are intrinsically fragile. They borrow from depositors with a promise to repay in full and on demand, and then mostly invest those deposits in longer-term loans. If depositors all suddenly decide to withdraw their money at once, as their contract with the bank entitles them to, the bank cannot meet the demand for funds. It will fail.

Depositors might be induced to withdraw their money by fear that the bank might be in trouble. Once this fear starts, it becomes self-fulfilling, because if there is any doubt about the bank's safety, depositors have every reason to withdraw their cash: they lose nothing by doing so. If one bank is perceived to be in danger, other banks are likely to come under suspicion too. Bank runs, once they start, tend to spread. Note that equity investors who fear a collapse in share prices face different incentives. As concern mounts, equity prices fall immediately, which makes it less attractive to sell. In a stockmarket, therefore, the price decline is somewhat self-limiting. Conversely, once a bank scare begins, there is no fall in price to deter further withdrawals. Deposits remain redeemable at par until the bank locks its doors.

At different points during the course of the 20th century, rich-country governments decided that banks were too vulnerable to this danger. They were also aware that bank failures could cause damage not just to depositors too slow to get their money out, but much more widely across the economy. Banks are needed, after all, not just for intermediation between lenders and borrowers but also to oil the wheels of everyday commerce. If the banking system collapses, the infrastructure for making and receiving payments collapses too, and the rest of the economy will follow close behind.

The solution, governments decided, was to assure depositors that banks were sound, by promising to step in themselves if need be. They promised to supply a safety net, by arranging for deposits to be insured and in other ways. If depositors could be persuaded that their savings were safe, there would be no danger of a bank run and banks would not fail—or would fail only rarely, and would not take the rest of the system down with them when they did. Confidence in the banks would be self-fulfilling, in just the same way as in the absence of a safety net lack of confidence is self-fulfilling. The cost of providing insurance would therefore be modest.

Recall that banks exist because they are an answer to the problem of moral hazard: they can monitor borrowers to make sure that the funds are not stolen or wasted. But who monitors the monitors? Banks are borrowers too: they borrow from depositors. What stops banks from wasting the money they borrow? Partly, the fact that depositors will not trust their money to an institution that they suspect will be reckless with it: they will place deposits only with banks that they judge to be safe.

Once governments arrange for deposits to be insured, however, there is no longer any reason for depositors to worry about the safety of their bank. They will get their money back anyway. So banks will be able to take bigger chances with the money they lend. They will be able to lend to bad risks, charging more in interest and therefore earning bigger profits. Higher lending rates will allow them to pay depositors more too, enabling them to bid for a bigger share of the market. So once depositors stop caring about the soundness of their banks, bad banking quickly crowds out good.

Once depositors stop caring about the soundness of their banks, bad banking quickly crowds out good

Enter the regulator

Governments have long understood this. Their solution is to monitor the banks themselves. The quid pro quo for deposit insurance—itself absolutely necessary, they say, to guard against runs—is careful supervision. Require the banks to keep a certain minimum proportion of their assets in reserve, monitor their lending policies, place restrictions on the businesses they can enter, and so forth. Having lifted the burden of bank supervision from depositors, there is only one possible course: nationalise it.

This all seems logical enough, but the success of the policy has been mixed at best. Banking and financial crises keep happening. And there is good specific evidence that deposit insurance contributes to financial instability, especially in developing countries. A recent study by Edward Kane of Boston College and Asli Demirguc-Kunt of the World Bank shows that where effective bank regulation is lacking (as it is in many developing countries), deposit insurance of the wrong kind does more harm than good. The wrong kind means, in particular, that it is too generous in its coverage; too well-funded, with reserves explicitly set aside for repayment of losses; and run by government officials rather than by the private sector.

This helps to explain why banks have been so deeply implicated in the financial crises of recent years, as the next section will explain. An exaggerated appetite for risk has been part of the problem. And as banks have become more sophisticated, even the best regulators have found it increasingly difficult to keep up.

So if depositors were responsible for supervision instead, would they do better? At first sight, professional, highly-trained regulators seem a more likely bet than ordinary depositors. The trouble is that regulators have allowed and even encouraged the banks to become more “efficient”—lending ever more, against the backing of a diminishing base of capital. Depositors acting on their own behalf would probably have resisted that trend and insisted on a more conservative and less “efficient” style of banking, which nonetheless had the considerable advantage of exposing their deposits to less risk.

Be that as it may, moral hazard, which banks were invented to tame, has now become one of the chief weaknesses in the international financial system. In reponse, governments and regulators have been trying to push more of the burden of supervision back to depositors and other parts of the private sector, without arousing fears of bank failure or otherwise destabilising the existing system. This is an extraordinarily difficult balancing act. The central role of banks in most, if not all, of the recent big financial crises in developing countries underlines just how difficult—and how important.

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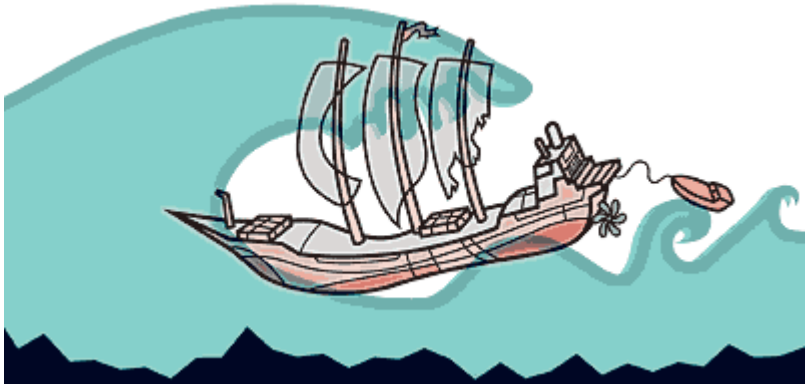
Sudden storms

May 1st 2003
From The Economist print edition



Financial crises don't come from nowhere. With effort and luck, some can be avoided

ONE way to improve the capital-flows trade-off—to combine more economic growth with less financial instability—would be to avoid at least some of the financial crises that might otherwise come along. But are they avoidable? They happen so often that it is natural to think that capital mobility and financial distress are inseparable: if a country wants the first, it will have to put up with the second. There is some truth in this. Access to more capital makes bigger crises feasible; every now and then, somewhere in the world, one is going to happen.

Is this because the same mistakes are made again and again, or is each crisis unique? The answer is yes to both: each crisis is unique, and the same mistakes are made again and again. However different the precise circumstances may be in each case, most of the scores of financial crisis seen in the past few decades do have certain central features in common. This is encouraging. Understanding these features and taking steps to deal with them could increase the safety of the global financial system without denying the developing countries the capital they need to grow quickly.

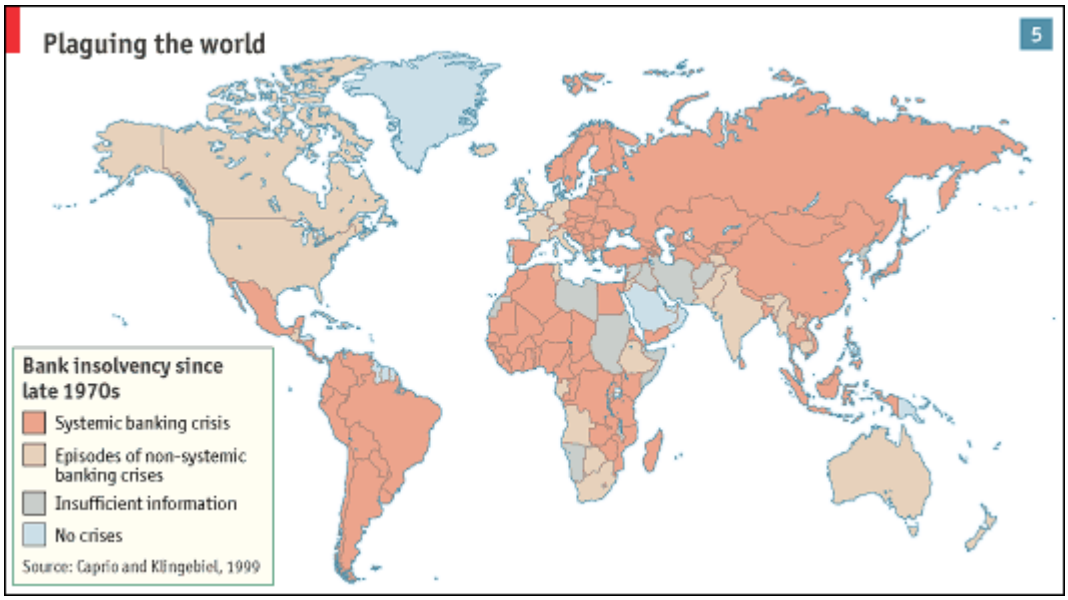
Banks are almost always deeply implicated when a financial crisis occurs—and banking crises are anything but rare (see map below). Given their role at the centre of any market-based financial system, it could hardly be otherwise. International bank flows, which declined so sharply during the 1990s, can still leave a country financially much more vulnerable than the figures suggest, because bank flows are so much more volatile than other kinds. Bank capital can switch quickly from inflow to outflow, so movements that seem small in absolute terms can exercise disproportionate influence.

Two kinds of banking weakness need to be distinguished: dangers specific to the borrowing country where the crisis starts, and risks that are due to capital moving across borders. As the crisis unfolds, these two interact. And the trouble often starts with financial liberalisation, a process that may aggravate both kinds of weakness. Talk about the perils of liberalisation makes some economic liberals uncomfortable, though financial economists, including many with strong pro-market leanings, have been pointing to the dangers of badly handled liberalisation for decades.

Falling standards

Every study of the East Asian crisis of the late 1990s has drawn attention to lax lending standards in the crisis countries. A lending boom preceded the breakdowns, and in each country most of the money went into risky assets such as property and equities rather than into productive investment. In Thailand, Indonesia and Malaysia the stock of lending for property accounted for as much as 40% of all lending before the crisis struck. Creditors were therefore unusually exposed to certain kinds of risk. Higher interest rates, for instance, would lower the value of the assets against which they had lent, at the same

time as making some of their loans non-performing.



Government involvement in many of the regions' banking systems made matters worse. Ministries urged banks to lend to specific sectors or firms with little regard for creditworthiness. “Connected lending”—that is, lending to the banks' own proprietors or to affiliated businesses—was tolerated or even encouraged. Ordinary standards of prudent loan appraisal were set aside.

Banks often lacked the resources, human and technological, to apply such standards in the first place. Their lending officers and risk-management systems were stretched beyond the limit of their competence by the sheer volume of business. The same was true of the bank supervisors' resources, such as they were. Not only did the banking authorities lack the skills and the manpower to do an effective job, but they were also usually under the thumb of ministries that were reluctant to see lending curtailed.

“Forbearance” was the rule—meaning permission to keep lending until the problems went away, and to hide the evidence in the meantime. Bad loans were “evergreened”: failing borrowers were allowed to service their debt with new loans. Accounting rules allowed such practices to be concealed. Nearly all of the crisis countries turned out to have had vastly greater volumes of non-performing loans on their financial institutions' books than the official figures admitted at the time. The official figure for South Korea's non-performing loans in 1996 was less than 1% of all loans—between one-tenth and one-twentieth of the true position.

In addition to weakly regulated banks, most of the crisis countries had, in effect, virtually unregulated quasi-banks operating alongside. Thailand's finance companies are the most notorious example. South Korea had its “merchant banks”: owned by the country's conglomerates, and more or less unregulated, they were at the forefront of credit expansion and of borrowing abroad. Indeed, the government allowed these ex-finance companies to borrow abroad only if the debt was short-term.

All of this was familiar from earlier financial breakdowns, looking back to the 1960s and before. Paradoxically, one of the least familiar aspects of the East Asian crisis, which helps to explain both its severity and the shock it caused around the world, is that many other aspects of economic policy were being handled well, and that the countries concerned seemed in most respects to be thriving.

In fact, East Asia was an extraordinary success story. Investors had every reason to feel confident. Even fiscal policy was mostly under control, which in developing countries is unusual. In a perverted way, it added to the financial danger. Investors believed that if banks and finance companies should fail, governments would be there to sort things out. The record showed that they were competent, and suggested that they had untapped fiscal resources in reserve.

The countries' success added to the dangers in another way: foreign capital was all the more readily drawn in. The sheer volume of additional inflows compounded the difficulties of monitoring and supervision. It added to the mood of optimism, so standards were relaxed still further. And it introduced the exchange rate as a new and potentially destabilising factor. Foreign inflows,

Deteriorating credit quality is easy to conceal so long as the price

while they lasted, supported the local currencies and added to the feeling that all was well. Governments, moreover, had promised to peg their currencies against the dollar; again, the markets assumed that they meant it, and that they knew what they were doing.

of property and other assets offered as collateral is going up

This sort of activity is strongly self-sustaining. While a bubble is inflating, reckless lending seems merely bold, and appropriately well-rewarded. Deteriorating credit quality is easy to conceal so long as the price of property and other assets offered as collateral is going up. The growth in lending fuels demand, so economic growth stays high as well. That reinforces the government's reputation for competence, so the boom continues.

Overborrowing syndrome

It is easy to see how this cycle of excess gets out of hand, but what starts it in the first place? Any news that spurs a rush of optimism can get things going. One potential catalyst is financial liberalisation, the very thing that first opens the credit taps. This has been known for decades. A classic text on development finance, by Ronald McKinnon of Stanford University, spelled out the dangers exactly 30 years ago.

A later volume of Mr McKinnon's again drew attention to the risks. Published six years before the crisis of 1997-98, it recounted South Korea's previous experience with overborrowing in the mid-1960s. Starting in 1965, financial and trade liberalisation had stimulated South Korea's growth, prompting a fundamental reappraisal of the country's prospects by foreign investors (not long before, economists had compared South Korea's prospects unfavourably with the North's). Liberalisation allowed capital to rush in, but the surge was too great; it forced inflation up and left the country struggling with the problem until the early 1980s.

Having started, and grown bigger, why does the bubble eventually burst? All it takes is a shift in perceptions, reversing the one that started it all off. After a few years of overborrowing, balance sheets start to look stretched. At some point, borrowers begin to think enough is enough. Here and there, asset sales begin as firms try to restore financial ratios to something closer to normal. Prices stop rising and then start falling. Inflows of capital slow and the currency comes under pressure.

The central bank would like to defend the currency by raising interest rates, but finds it cannot because the weakness of the banks has suddenly become clear. All at once the abyss opens up, and there is a stampede to get away from it. Panic and forced selling accelerate the decline in property and equity prices into a crash. The government's reputation for competence tanks. As capital flees, pressures on the currency force it to give way. Lenders' unwarranted faith in the stability of the currency is important both in inflating the bubble and then in worsening the effects when the bubble bursts.

Lenders' unwarranted faith in the stability of the currency is important both in inflating the bubble and then in worsening the effects when the bubble bursts

In the middle phase, while the bubble is inflating, multiple layers of moral hazard are in play. Domestic lenders are not effectively supervised either by regulators or (thanks to explicit and implicit deposit protection) by the markets. Foreign lenders likewise perform their death-defying feats over a safety net extended by their home governments—with some additional assurance of protection from borrowing-country governments and, should things turn really bad, from the IMF.

What little discipline markets might supply under these circumstances is undone by lack of information. Lenders' unwarranted faith in the stability of the currency is important both in inflating the bubble and then in worsening the effects when the bubble bursts. The promise to defend the currency creates a kind of moral hazard too: an exaggerated sense of safety, leading people to do things which they would otherwise regard as too risky or too costly.

Looking back at the beginning of the 1990s, with the East Asian debacle yet to come, Mr McKinnon put it like this:

> [We] know that in any purely private capital market each individual borrower faces an upward-sloping supply curve for finance. That is not really a distortion. The more that is borrowed, the riskier the loan gets at the margin. The upward-sloping supply curve imposed by private lenders accurately reflects the increasing riskiness of the private borrower as he

increases his exposure.

> Consider instead the world of the 1970s and 1980s, where governments guarantee all credit flows. The host government in the borrowing country guarantees private foreign credits, either officially or unofficially. In the lending countries we have official export-import banks and deposit insurance for the commercial banks. Consequently, the normal upward-sloping supply curve for finance did not face individual private borrowers in the third world during these two decades of huge accumulation of external debts. Because of the government guarantees that were involved, they could borrow at a virtually flat rate of interest.

Exactly the same thing happened all over again in the 1990s, and not just in East Asia but in many other countries too. Nobody should suppose for a moment that, after East Asia, it cannot happen again. Turkey and Argentina, to name but two, already confirm otherwise.

Is it infectious?

This account of the forces that drive the cycle of optimism, overborrowing (especially from abroad), excessive risk-taking and crisis may seem plausible for any given individual economy—but one of the hallmarks of recent financial stress has been its multinational character. One country gets into financial difficulties, then another and another. This co-called contagion need not be confined to particular regions. The Russian financial crisis of 1998, itself a kind of aftershock from the East Asian crisis, put Brazil and other Latin American economies under pressure almost immediately.

Some economists insist that this apparent contagion is not real. They argue that countries make their own way into a position of financial weakness and vulnerability, essentially in the way just described. They object to the term contagion because it implies that the countries and governments concerned are not to blame. Bad news about a neighbouring or similar economy, they say, merely alerts investors to problems elsewhere the markets had been unaware of, or willing to ignore.

On this view, it is not so much the disease that spreads as awareness of the disease. Financial crises may tend to appear in clusters, but the sources of the problem are fundamentally national in character: that is, they spring from the mistakes of borrowers in, and lenders to, a particular country, not from some global propensity to system-wide breakdown.

It is true that contagion will not bring down a financial system which is strong, and that a crisis needs strictly domestic material to work with. Also, some of the economic shocks that trigger crises in more than one country are global or regional in their effects to begin with, such as a change in world interest rates, or a big movement in the dollar or yen, or a big change in the price of oil. If events of that kind start a cluster of crises, contagion is not to blame (any more than one would call it contagion when an earthquake causes neighbouring buildings to collapse).

The fact remains that even an economy which has been rendered vulnerable by weak supervision, excessive optimism and prolonged overborrowing is not necessarily doomed. If it is lucky, it might pass quietly through that period of danger and emerge on the other side with its vulnerabilities lessened, either by acts of policy or merely as a by-product of advancing economic development. If it is unlucky, it will be affected by bad news just when it is most susceptible. When this happens, it seems reasonable to call it contagion.

A crisis in a neighbouring or similar country might suffice to bring on financial difficulties in just the same way as a purely domestic reappraisal of economic prospects could do: bad news that forces a rethink. Often, cross-border financial flows also come into play, exerting their own direct and powerful influence on events. The evidence points clearly to a “common banker” effect: if two countries have borrowed from the same lender, when one gets into trouble the other can expect to face a squeeze as well, regardless of differences in underlying economic conditions.

There are other channels of contagion too. Equity markets have spells of moving in step, especially in downturns. Rich-country portfolio managers have a tendency to herd together when it comes to investing in emerging markets. When a bank or portfolio manager faces losses in one developing country, it may choose (or be forced by regulators) to sell assets in other markets to shore up its position. If one country devalues its currency, competing exporters come under pressure to do the same, regardless of the effect devaluation might have on corporate and financial balance sheets. All of these factors link economies together.

Because of technology, financial markets move faster than ever before. Partly for the same reason, financial institutions are bigger than ever. When a big rich-country bank changes its mind about the prospects of a particular emerging economy, the effect on asset prices in that economy can be dramatic; all the more so if other rich-country banks decide to join in.

In short, the possibility of contagion certainly adds to the risks of relying on foreign capital, shifting the balance of pros and cons away from openness to capital. For countries that nonetheless still seek access to foreign capital, it underlines the relative attractions of forms that will move only slowly when circumstances change, notably FDI. And it emphasises the dangers of the most mobile and volatile form of capital, short-term bank debt.

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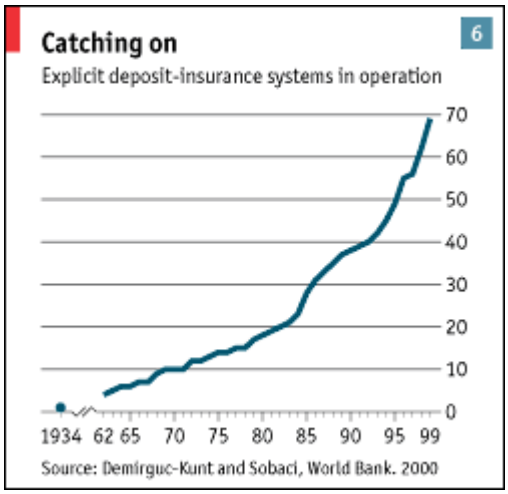
Safety first

May 1st 2003
From The Economist print edition

How to handle bank regulation



THE modern history of financial crises emphasises the importance of banks, their tendency to lend recklessly, and the role that deposit insurance plays in creating moral hazard. So are governments having second thoughts about their deposit-insurance schemes? Not a bit of it. Many of them regard deposit insurance as politically unavoidable, and they and their financial regulators are pretty relaxed about moral hazard. There is plenty of talk, and even some action, in regulatory circles about the need for greater market discipline, but no radical rethink of deposit insurance is under way. Rich-country governments continue to export the idea around the world, advising developing countries that deposit insurance is a necessary part of a mature and sophisticated financial system. The number of schemes in place world-wide has been rising steadily for decades (see chart 6).

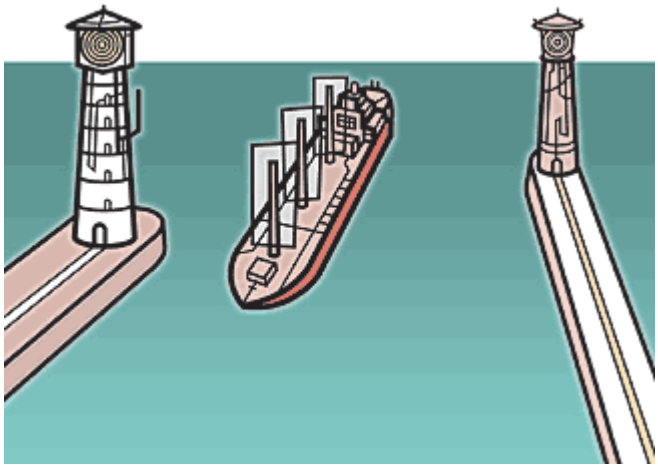
If deposit insurance and other strands of the official safety-net were dispensed with altogether, an utterly different—and much more cautious—sort of banking would necessarily follow. But this is not going to happen. As a matter of practical politics, abolishing deposit insurance is out of the question. If the safety-net cannot be removed, how then might it be changed to mitigate some of its most harmful aspects? And what other reforms of the way countries regulate banks would help alongside?

In the aftermath of the savings-and-loan calamity of the 1980s, American legislators passed the Federal Deposit Insurance Corporation Improvement Act (FDICIA). This new law contained several useful measures that need to be adopted much more widely, and especially in the developing countries. The strategy adopted was, first, to narrow the scope of deposit insurance, so that there would be more uninsured creditors with an interest in monitoring; second, to make it harder for regulators and governments to bail out failing banks; and third, to shield bank supervisors from political pressures to exercise forbearance.

A crucial feature of the reforms is the mechanism for “structured early intervention and resolution” (SEIR). Its rules force regulators to act promptly, with a degree of rigour that varies according to the amount of capital retained by the bank or banks concerned. The law defines “well-capitalised” banks as those with capital equal to more than 10% of their assets, with capital and assets both weighted for risk; “adequately capitalised” banks as those with capital of 8-10% of assets; and so on through “under-capitalised” and “significantly under-capitalised”, down to “critically under-capitalised”, with equity of less than 2% of assets.

Well-capitalised banks are rewarded for their prudence with minimal regulation. The regulatory burden—with only limited discretion given to the regulators—mounts as the cushion of capital gets thinner. FDICIA requires regulators to tell under-capitalised banks to curb their asset growth, to seek permission for other expansion of their business (such as opening new offices), and to come up with a plan for restoring their capital base. In the case of critically under-capitalised banks, the law tells regulators to close them or sell them, and to require interest payments to unprotected creditors to be suspended.

More generally, the Federal Deposit Insurance Corporation is under an explicit obligation to deal with failed banks in a way that minimises the cost to the deposit-insurance fund. Bail-outs that protect all creditors are not ruled out altogether, in recognition of the fact that sometimes a bank failure might pose a genuine risk to the financial system as a whole. But any such comprehensive bail-out requires the explicit agreement of the president of the United States, two-thirds of the governors of the Federal Reserve and two-thirds of the FDIC's directors.



FDICIA substantially implemented the earlier advice of George Benston and George Kaufman, two of America's leading financial economists, long-time deposit-insurance sceptics and advocates of greater market discipline over banks. They welcomed the change in the rules, but argue that even in America more still needs to be done. Elsewhere, they point out, measures like SEIR, to ensure prompt corrective action when banks get into trouble, are few and far between.

Starting in the 1980s, rich-country governments began to co-operate more closely on bank regulation. The growth of cross-border lending made co-ordination necessary, it was argued, otherwise countries with stricter regulation would put their banks at a competitive disadvantage against more mildly regulated banks based abroad. The Basel Committee, founded in 1975 by the rich G10 countries (plus Luxembourg), was given a larger role, and undertook to bring the different national systems of capital-adequacy regulation closer together.

In 1988 an accord was reached. It was based on a two-tier definition of capital, together with a method of weighting risks so that loans and other assets could be measured against capital in a more meaningful way. According to this standard, banks had to retain “tier-1 capital” (equity, mostly) equivalent to 4% of their risk-weighted assets. In addition they had to keep supplementary “tier-2 capital” (including some kinds of debt, loan-loss reserves and, to please the Japanese, 45% of unrealised gains on securities) equivalent to another 4%.

All this was directed at credit risk: the risk that a loan would go bad. In 1996 the accord was amended to take account also of market risk: the risk that the prices of securities or other investments on the bank's trading books would fall, exposing the bank to losses. Banks were allowed to use their own internal models for measuring market risk, subject to some oversight.

The accord did not work well. Criticism has centred chiefly on the credit-risk weights, which were based on very broad categories of asset, and therefore produced judgments far out of line with the market's own finer-grained risk assessments. In reality, risks vary widely for assets within each of the categories. Loans to OECD governments, for instance, which are assigned a zero risk-weight, may vary from rock-solid to not-so-solid. (Mexico, South Korea and Turkey are members of the OECD.) The accord rates loans to companies as riskier than loans to governments—but the market knows that a loan to Microsoft is safer than a loan to Venezuela.

These unduly broad categories created opportunities for banks to game the system, reducing their burden of regulatory capital for any given level of risk (or, conversely, increasing their exposure to risk for any given level of capital). In any case, the idea that aggregate risk can be estimated by adding up risks in the different categories is wrong in principle. Managing a portfolio to reduce risk involves combining assets with different risks in such a way that the hazards offset each other. The accord, in effect, denies the risk-reducing benefits of diversification.

Worst of all, the accord probably contributed to the Asian crisis. Short-term interbank lending was given a low risk-weight—just a fifth of the weight attached to longer-term lending, or to loans to private non-bank borrowers. Short-term interbank lending played a big part in the region's disastrous credit expansion, with the local banks re-lending the proceeds at high interest rates and in local currency (thus exposing themselves, in addition, to exchange-rate risk).

Try again

So for the past few years the Basel committee has been at work designing a new accord, Basel 2, which is meant to be finalised by the end of this year and to come into force by the end of 2006. In addition to a great deal of technical tinkering, there are three main proposals. The first is to increase the number of risk “buckets”. The second is to give ratings produced by private agencies such as Standard & Poor's a role in calculating the new credit-risk weights. The third is to let banks use their own internal ratings to calculate the capital required for credit-risk purposes (extending the approach used at present for estimating market risk).

George Benston, George Kaufman and a group of other financial economists who meet regularly as the Shadow Financial Regulatory Committee (SFRC), which lobbies for reform, argue that even this new, improved accord will have serious defects. The adding-up-categories fallacy is still there (though ameliorated by the increase in the number of categories). And relying on private rating agencies also seems questionable, however desirable it may be in principle to draw on wider sources of information. Academic research suggests that the agencies change their ratings too slowly as new information becomes available. Certainly, the agencies' record in the run-up to the East Asian financial crisis was hardly impressive, even if nobody else did any better.

But there are other problems with Basel 2 as well. Banks will design assets to fit particular categories of risk, bending whatever connection there might previously have been between a rating applied after the fact and the level of risk. The agencies themselves will also face a form of moral hazard: they will be tempted to debase their ratings in order to bring banks to their door. As the SFRC puts it, “If the primary constituency for new ratings is banks for regulatory purposes rather than investors, standards are likely to deteriorate.”

The proposal to let banks, under supervision, rely more heavily on their own credit ratings is again guided by a good idea—namely, to broaden the base of market-based information feeding into the regulatory process. But it is unclear how the regulators will gauge the accuracy of the banks' ratings, or establish comparability between one bank's method and another's, or what happens if the ratings turn out to be wrong.

Despite all the delays so far, the chances are that something like Basel 2 as it now stands will be implemented in due course—though if it is, its application will be far from comprehensive. America's regulators recently announced that they intend to apply the new rules to fewer than a dozen of their banks, leaving thousands of others to continue with the existing rules. Europe's regulators are aghast. It all makes the case for a thorough rethink seem stronger than ever.

Another way

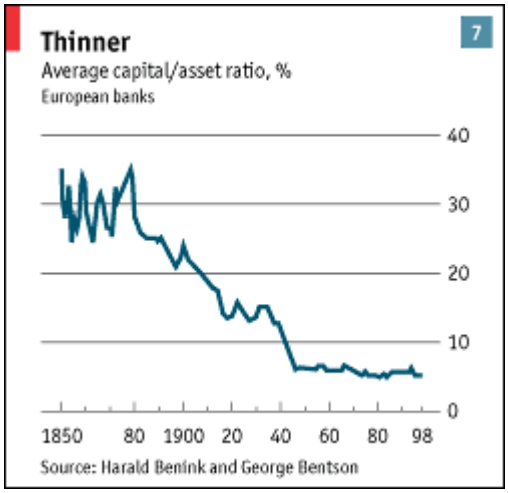
The SFRC suggests an entirely different method, drawing heavily on FDICIA in its approach to deposit insurance and “early intervention”, and in other ways too. The group's alternative has five main parts.

First, measure each bank's capital in a way that reflects market (not book) values and disclose this to the markets regularly. Second, require banks to maintain a level of capital capable of absorbing “almost all losses that would be incurred by reasonably prudent management”. Third, let banks meet this capital requirement by issuing subordinated debt (such as uninsured certificates of deposit: in effect, debt which will not be recovered if the bank fails). Fourth, not merely allow but require large banks to issue and regularly reissue a particular form of subordinated debt. Fifth, adopt an improved version of SEIR. The idea is to furnish the financial markets with both the information and the incentives they need to monitor the banks.

In this scheme there would be no risk-weighting. Weights may make sense in principle but in practice, the group argues, they distort lending decisions and fail to convey the information they are meant to. So required capital should be based on a single market-value measure of loans and off-balance-sheet commitments. The muscle of the system is provided by a higher basic capital requirement—the group thinks it should be 10% of total assets—together with FDICIA-style early intervention, and the extra discipline that would come from the use of subordinated debt.

Banks regard a higher ratio of required capital as a tax, which in a way it is. But a ratio of 10% of total assets does not seem that onerous. Until deposit insurance started in America in 1933, banks

maintained capital-to-asset ratios of roughly 15%. Mr Benston and Harald Benink, a European collaborator, have shown that before the creation of official safety-nets in Europe, banks had capital-to-asset ratios of as much as 20% (see chart 7). American banks currently operate with equity-to-asset ratios as little as half those of other financial institutions (such as investment banks, insurance companies and consumer-credit firms).



Moreover, the costs to banks of requiring a higher capital-to-asset ratio need not be great. In some cases it would be zero. Allowing subordinated debt to be counted as capital would help a lot. Many well-run banks already have such capital, and would probably find it cheaper to issue subordinated debt than issuing equity. The main difficulty is not the cost, but the further rules that would be required to ensure that this debt really would be available to meet any losses. If the discipline of subordinated debt is to work, there must be no possibility that the holders of the debt would be bailed out.

Discipline is also the reason why, on this scheme, big banks would be required, not merely allowed, to issue subordinated debt. The SFRC recommends that 2% of assets and off-balance-sheet commitments be backed this way. That would create a group of investors with the best possible reason to monitor the banks' safety: in the event of failure, the holders of subordinated debt lose their money.

Shareholders, too, lose their money when a bank fails. Why, then, does subordinated debt add discipline? The answer is that the owner of subordinated debt, unlike a shareholder, has nothing to gain from a troubled bank gambling on redemption by making riskier and potentially more profitable loans. The subordinated-debt holder receives at most the interest on his debt; he has no stake in the upside of any hazardous escape plans, whereas shareholders stand to win the jackpot. This is why the subordinated-debt holder is a better disciplinarian than the banks' owners.

Given all this, subordinated debt does not sound very attractive. Why would anybody buy this uninsured debt if the only return is interest rather than a possible share-price bonanza? Banks would have to induce investors to buy it by paying a sufficiently generous rate of interest. Here lies the beauty of the idea. For a bank judged by the market to be well capitalised and extremely safe, the rate would be low; for a bank judged to be under-capitalised and risky, it would be high. So the cost of capital for safe banks would be lower than for risky banks, which is as it should be. Also, the rate demanded in the market for the debt would be a revealing indicator of perceived risk. Changes in the yield on the relevant subordinated debt could even be given a regulatory role, triggering various stages of early intervention to resolve difficulties at troubled banks.

No doubt there are practical problems in all this, but the basic approach seems a more direct and potentially far more fruitful way of introducing market discipline into bank regulation than Basel 2 as it now stands. At a minimum, a modest version of the subordinated-debt idea should be grafted on to the existing plan as an experiment. Yet whichever basic method is adopted—Basel's finely tuned risk-weights, as seems most likely, or the subordinated-debt approach with early intervention, which may have to wait for Basel 3—it will still fall to national regulators to apply the letter and the spirit of the new rules. In many countries they have been pretty inept at applying the letter and spirit of the old ones.

In the world of financial regulation, forgiveness and forbearance are not virtues. That is why the most urgent change to the way many countries regulate banks is the creation of a legal framework that makes it harder for regulators to turn a blind eye. America's FDICIA shows that this can be done. Other countries should adopt similar measures. These would serve a useful purpose whatever the Basel committee eventually comes up with. If banks can be made safer, that will go a long way towards making financial globalisation much safer as well.

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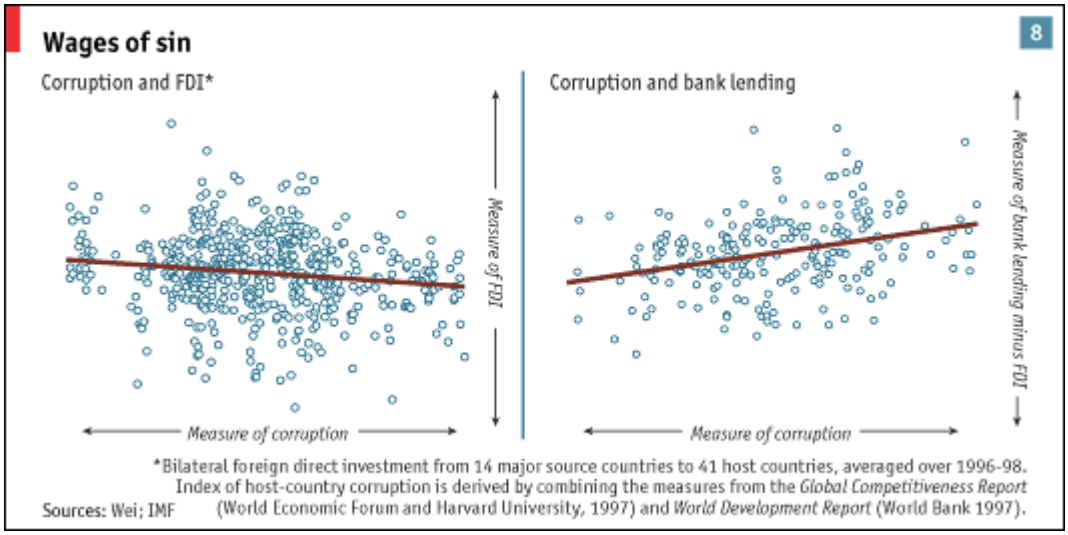
Shipbuilding

May 1st 2003
From The Economist print edition

Developing-country governments still have a lot of work to do if they want to attract the right sort of foreign capital



BETTER bank regulation is as much a task for rich-country as for poor-country governments. But in addition, the developing countries also need to implement many other financial reforms and improvements of their own. Few of them have the capacity to put imported capital safely to work. This capacity is something that governments can build, but a lot needs to be put right before openness to capital can be relied on to bring net benefits rather than net disappointment.

Reducing corruption would be high on the list even if economic efficiency were the only concern. Corruption particularly discourages inflows of FDI, the safest and most productive kind of capital inflow, so relatively speaking it favours bank lending, the riskiest kind of capital (see chart 8).

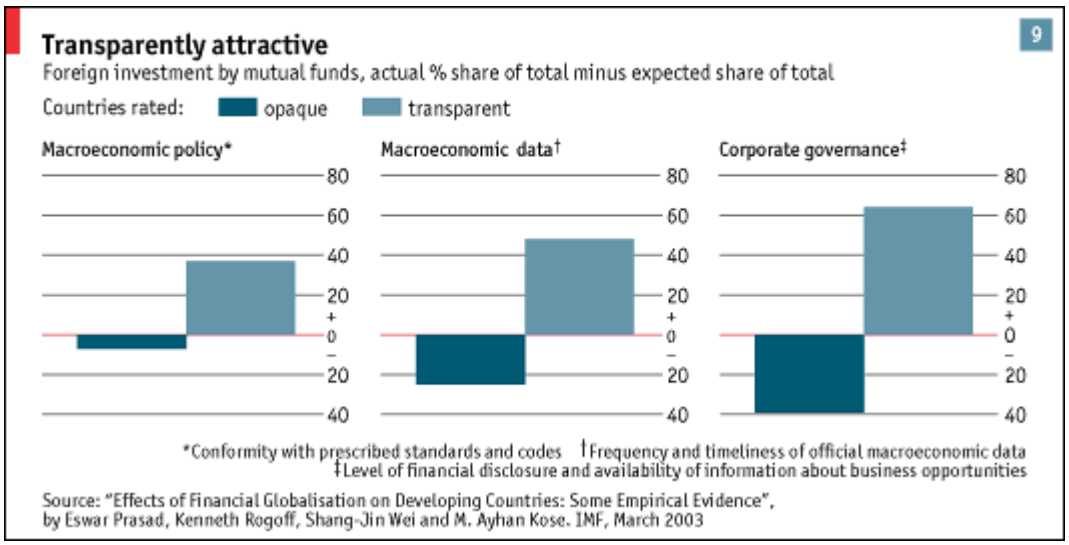
Work on the connection between corruption and the mix of capital inflows has been reviewed in a paper just published by the IMF. However corruption is measured, the answer comes out the same: corruption discourages inward FDI. Indeed, it appears to discourage it even more than do high corporate taxes.

Many developing-country governments, keen nowadays to attract FDI, try to appeal to investors by cutting corporate taxes or by offering subsidies. This often works, but the cost is quite heavy, and goes beyond the mere fiscal outlay or forgone revenue. Governments in most poor countries have to rely on a narrow tax base. They find it difficult to pay for social spending and economic infrastructure while keeping their own borrowing under control. Macroeconomic stability, as noted earlier, is an important contributor to financial safety. Special tax breaks for FDI may militate against such stability—and run a far greater risk, too, of distorting FDI decisions in favour of inefficient projects. In every respect, curbing corruption is a far better method of attracting FDI.

Reducing corruption is hard but not impossible. Measures include explicit restrictions on connected lending, better accounting standards and greater disclosure of financial information (and not just for the banks). In many countries, legal reforms will be needed as well. A constant theme of much of the recent research on finance and development is the importance of strong property rights. Without them, it is difficult, for instance, to offer collateral against a loan, or to resolve bankruptcies quickly and smoothly.

Faster and more accurate disclosure of information too is desirable in itself, for governments as well as for banks and private companies. A study by Gaston Gelos and Shang-Jin Wei, quoted in the IMF paper,

looked at the investments of international equity funds between 1996 and 2000 to see if there was a connection with “transparency”, measured in a number of different ways. It examined disclosure not just in the corporate sector but also in the release of official macroeconomic data and in the running of macroeconomic policy. All three aspects of transparency were found to be related to inward portfolio flows, even after allowing for the effect of many other factors (for example, incomes and market liquidity).



And these effects were big. For instance, on the macroeconomic-data measure, transparent countries received a share of global equity investment that was 48 percentage points higher than their market capitalisation (as a share of global market capitalisation) would suggest. Non-transparent countries received a share that was 25 percentage points lower than the same benchmark (see chart 9).

The same study found that herding among investors was substantially lower for countries with good disclosure than for the rest—presumably because greater transparency gives investors something more substantial to go on than what other investors are doing. Less herding is a good thing: when investors follow the crowd, they amplify the economic cycle, driving output and asset prices higher in booms and lower in slumps.

Also, in the event of a financial crisis, capital flight seems to be less of a problem in countries with better transparency. Again, this may be because information equips investors to see beyond the short-term emergency to more reassuring long-term fundamentals. “Overall,” the study concludes, “the data suggest that an improvement in transparency might very well reduce the so-called sudden-stop phenomenon of ‘hot money', and hence increase the stability of the domestic financial market in a developing country.”

There is evidence that ownership of the banks and other financial institutions in developing countries matters a lot. Most governments restrict foreign ownership of banks. State ownership, on the other hand, is typically extensive. It would be far better the other way round.

Most governments restrict foreign ownership of banks. State ownership, on the other hand, is typically extensive. It would be far better the other way round

Foreign ownership of banks is just a particular form of FDI. In many ways, therefore, the benefits to the host country of foreign-owned banks are simply the financial-sector equivalent of the broader benefits of FDI. These include not just the initial capital inflow itself but also the introduction of better technology and new management skills, not to mention greater competition for the existing domestic institutions. But in finance there are additional advantages as well. The task of financial regulators is easier if foreigners come into the market and establish new and higher standards. With a heavy presence of foreigners, the government is much less likely to bail out the banks en masse if they get into trouble. Uninsured depositors will accordingly feel that much less secure—which is all to the good, from the standpoint of discipline and monitoring.

Banking-sector FDI also helps to fight corruption. Foreign-owned banks have their reputations at home and around the world to consider, not to mention their home-country regulators, so they will be less susceptible to corruption than incumbent domestic banks. They also have good reason to monitor what

domestic banks are doing, and to expose corruption when they find it. From their point of view, improper conduct is a kind of unfair competition that puts them at a disadvantage.

Possibly most important of all, banking-sector FDI promotes diversification, which is a good way of reducing risk. The business of domestic banks in developing countries tends to be heavily concentrated at home. If the local economy turns down, all of their activities are exposed. Foreign banks have a far wider spread of risk, and can call on head office to help if need be.

For every advantage that banking FDI offers the emerging-market economy, state ownership brings with it a corresponding disadvantage. State-owned banks often institutionalise practices that would be called questionable or corrupt if undertaken by private banks. Connected lending, for instance, is not so much a consequence of state ownership as its very purpose: the whole idea is to make lending decisions on the basis of non-economic tests. This means state-owned banks must be expected to make losses, and will have to be sheltered from competition. Regulatory forbearance, in the same way, is not just likely, it is required. Monitoring by depositors and other creditors will be minimal: the promise of bail-out is as clear as it possibly can be. The evidence confirms that countries with the highest proportion of state-owned banks have the highest bank operating costs and the largest proportion of non-performing loans.

In addition to promoting access to information and curbing corruption—where greater foreign ownership can be of great help—developing-country governments need to weigh the case for explicit restrictions on certain kinds of financial activity. In systems that are otherwise clean and well-run, the need for further measures might be limited. Even then, some action may seem advisable, especially since bank regulation is likely to remain far from ideal. But in systems that are neither clean nor well-run, and where governments would find it difficult to put this right by more direct means, narrower restrictions may be necessary. Two kinds of capital stand out: short-term debt, and debt denominated in foreign currency. Short-term foreign-currency debt, combining the hazards of both, is therefore a prime concern.

Unpegged

Today the exchange-rate danger, at least, is smaller than before—not because currencies are more stable, but because the fragility of systems that merely appear to be stable is better understood. Fixed but adjustable exchange rates helped to worsen the plight of the East Asian economies and others in the late 1990s. The promise of a stable currency helped to draw in too much of the wrong sort of capital. Then, when events forced a devaluation, the economies concerned found themselves in trouble twice over—once for overborrowing in the first place, and then again because many of those debts had to be repaid in dollars or other hard currencies which had appreciated in the meantime.

The economic problem is even worse than this, because a heavy burden of foreign-currency debt makes it difficult for the government to cushion an economic slowdown in the orthodox way, by lowering interest rates. If it does that, it is likely to speed the flow of capital out of the country. This will drive the currency down further, increasing the burden of foreign debt yet again and dragging the economy into an even more ferocious recession.

Here, if nowhere else, lessons have been learned. All over the developing world, fixed but adjustable currencies have been replaced by more flexibly managed regimes (either pure floats or, more commonly, managed floats). Under floating-currency arrangements, the foreign investor comes in with a more realistic idea of the exchange-rate risk, and if the economy does get into trouble, the simple one-way bet of withdrawing capital before the currency peg gives way becomes more complicated. That is likely to encourage stability, both by tempering the inflow of capital during upswings of market sentiment and by encouraging long-term flows at the expense of short-term ones.

In other respects as well, international monetary arrangements are improving, albeit more slowly. The IMF, for instance, has a keener sense of the harm that can be done by letting investors believe that it will protect their investments come what may: moral hazard, yet again. A great deal of attention has concentrated lately on making sure that, once a crisis strikes, investors fully share in the losses—and that they will be well aware of this in advance.

International monetary arrangements are improving, albeit slowly

But although understanding of the IMF's role has improved, policy for the most part has not. The main reason is that big financial crises are usually political crises as well. It is the way of the world that, at such times, economic principles are swiftly set aside. Generous IMF support, pushed through by powerful members (notably the United States), has often been granted for political rather than economic reasons,

and will continue to be.

Also, as the Basel bank-regulation saga confirms, institutional reform that requires international consensus takes years, if it happens at all. Anne Krueger, the Fund's deputy managing director, has proposed a scheme for dealing with “sovereign bankruptcy”, which among other things would allow investors' losses on loans to developing countries to be apportioned faster and more predictably. It is a good plan, and has won the support of many expert observers. But many governments, including America's, are not keen. At the moment, its prospects look poor.

Besides, the extraordinary attention paid to reforms of the “international architecture” over the past five years has been out of proportion to its real importance. As this survey has argued, it is the quality of national financial policy, in rich countries and poor countries alike, that decides the safety of the global capital market. If that policy is wrong, no reform of the IMF or changes to other aspects of the international architecture, however ingenious, is going to make cross-border capital safe and productive.

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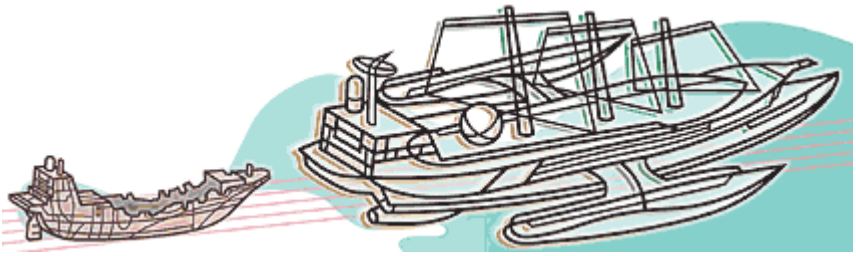
A slightly circuitous route

May 1st 2003
From The Economist print edition



Where capital controls make sense

MALAYSIA responded to the financial crisis of 1997-98 by violating one of the most sacred canons of economic orthodoxy: it imposed exchange controls. The government started supervising all foreign-currency transactions for financial (as opposed to trade) purposes. The policy was draconian, especially by the standards of the financial freedom the country had enjoyed up till then. Suddenly it was illegal to take even $100 abroad. The aim was to allow the authorities to ease fiscal and monetary policy without provoking massive capital flight. Some economists think that the policy was a success, and advocate something similar for other developing countries. A few even see it as a way to prevent crises in the first place, not just to help deal with existing emergencies. Are they right?

They have a point. Liberal economists, who for years rejected the mere possibility that capital controls might make sense, need to acknowledge that the long-standing orthodox prohibition on any and all of them was far too confident. For the IMF,capital-account liberalisation as quickly as possible was until recently an article of faith. The Fund told South Korea to press on with liberalising its capital account even as the crisis of 1997-98 was unfolding.

This newspaper, too, long maintained that capital controls are always wrong. Yet the evidence reviewed in this survey shows that the global capital market is a turbulent and dangerous place, especially for poorly developed economies that may be ill-equipped to navigate it. To be sure, capital controls are not the best way to prepare; but for some countries, imposing certain kinds of control on capital will be wiser than making no preparations at all.

In rich economies, with their deep and diversified financial markets, honest and competent regulators, and macroeconomic policies that keep public borrowing and inflation in check, a liberal regime for capital flows works best. Indeed, it works so well that the policy arouses next to no debate. There may be arguments about the details of bank regulation or fiscal policy, but nobody seriously proposes that the United States, say, should introduce exchange controls. Even if it were still possible to control capital flows that way—which it would not be, given the sophistication of America's financial institutions—who would want to? The benefits of financial integration are clear to all investors, and any economic costs vanish by comparison. Moreover, in most rich countries the ability to move capital across borders is seen as a matter of personal liberty. If a government wanted to stop its citizens from moving their savings abroad, it would have a lot of explaining to do.

Timing is all

As a medium- or long-term goal, emerging-market economies too should aspire to regulate cross-border capital as lightly as rich countries do—as a matter both of economic efficiency and of individual freedom. Nor does this mean that they must wait until they are rich before they liberalise capital: that would keep them poor much longer than necessary. What it does mean is that they must improve the standard of their monetary and fiscal policies; deepen, diversify and deregulate their domestic financial systems (not least by allowing foreign ownership of banks and other financial institutions); and upgrade their

standards of financial supervision (especially of banks).

Once they are more like rich countries in these three respects, and long before they have closed the income gap, they can liberalise access to foreign capital in comparative safety. All the while they should be encouraging inflows of FDI—not with subsidies, but by curbing corruption and strengthening property rights. When they start to reach those higher standards of economic policy and institutions, the benefits of inward portfolio investment and, later, offshore bank finance will increasingly outweigh the costs as well.

It is a cumulative process, and each step poses difficulties of its own. The need for better bank regulation is nowadays widely understood—but, judging by experience to date, that does not make the underlying dilemma of systemic stability and moral hazard any easier to resolve.

Essentials

The importance of macroeconomic stability, and especially of fiscal conservatism, continues to be underestimated. Yet if a government cannot keep its borrowing in check, it must either force domestic banks to absorb its debt (ruining any chance of creating a profitable, lightly regulated and efficient banking system) or else simply print money, thereby fuelling inflation and destabilising the currency. Now that floating exchange rates predominate, fiscal caution is even more important than before. The simplest principles of public finance are still the foundation for everything else. This is one article of faith the IMF need not renounce.

But until progress in these areas is well under way, some kinds of restriction on inflows (not outflows) of capital will make sense for many developing countries. Chile's well-known system of holding-period taxes subjected imports of capital to a one-year 30% non-interest-bearing deposit. It failed in its stated goal of reducing total capital movements, but managed to tilt the balance away from short-term towards longer-term inflows. In that respect, it was a success worth emulating.

A tax on short-term inflows has the advantages of relative simplicity and transparency. It resists bureaucratic subversion. Moreover, just as tariffs are a more efficient way to restrict trade than import quotas, so taxes are a much less costly way of managing capital inflows than blunt restrictions on quantities. A regime such as Chile's still allows access to short-term capital, albeit at a price.

Over time, it seems the regime became less effective and more subject to evasion, but that is of no great concern. As the financial system becomes more sophisticated, the need to discourage short-term inflows recedes anyway. The important thing is to ensure that standards of supervision rise in tandem with the institutions' growing depth and breadth.

Until recently, financial orthodoxy set its face against restrictions of the Chilean sort. They still make the IMF uncomfortable. In its free-trade negotiations with Chile and Singapore, the United States has also frowned on capital-account restrictions, though it was willing to compromise. Instead of reluctantly acquiescing, rich–country governments and the Fund need to start recommending such policies. If they must, they can tell themselves that holding-period taxes are not really capital controls at all, but simply another form of prudential regulation. In any event, developing countries should be advised to use this method until their financial systems are ready to participate properly in the global capital market.

Rich-country banks will oppose this, because they would be the principal losers from new impediments to short-term bank inflows to developing countries. But, helpfully if incidentally, their opposition might oblige the IMF and its most powerful members to endorse such policies explicitly, instead of merely tolerating them. This would make it clear that the global capital market is not, as is sometimes alleged, being run for the benefit of rich-country banks.

No greater prize

The world's poorer countries have a great deal to gain from the global market for capital, and should do their best to take advantage of it. But they need to approach the opportunity more cautiously than in the past, and better prepared. If rich countries also improve their own financial policies—which they should, in their own interests—the market will become even safer for all its participants. The international market for capital is already vast, but its potential for promoting growth where it matters most has hardly begun

to be tapped.

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Airlines

A way out of the wilderness

May 1st 2003
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The Flight Collection

It is time for aviation to snatch victory from the jaws of disaster

Get article background

THE biggest danger facing the global airline industry is not the effects of terrorism, war, SARS and economic downturn. It is that these blows, which have helped ground three national flag carriers and force two American airlines into Chapter 11 bankruptcy, will divert attention from the inherent weaknesses of aviation, which they have exacerbated. As in the crisis that attended the first Gulf war, many airlines hope that traffic will soon bounce back, and a few catastrophic years will be followed by fuller planes, happier passengers and a return to profitability. Yet the industry's problems are deeper—and older—than the trauma of the past two years implies. Alan Mulally, chief executive of Boeing Commercial Airplane Group, points out that airlines have not earned enough profit to cover the cost of their capital over the past 30 years.

Concentration on the immediate crisis is understandable. IATA, the industry's trade association, reckons that $30 billion has been lost since September 11th 2001. That is ascribed—unsurprisingly—to factors that the industry can do nothing about. Airlines in America have to endure traffic 17% lower than last spring, when it was 10% lower than in spring 2001. On Atlantic and Pacific routes, traffic was already 25% lower than a year earlier, before SARS struck. The big American carriers alone have debts of $100 billion on a combined stockmarket value of less than $3 billion.

True, in recent weeks there have been encouraging signs. Concessions that American Airlines belatedly wrung from its workers—in pay cuts and more flexible working—kept it clear of Chapter 11. United, although bankrupt, this week agreed new working arrangements that could produce big savings. But such responses alone are not enough.

A worrying lack of concentration

As the centenary of the first powered flight approaches in December, the industry it launched is still remarkably primitive. The car industry, created not long after the Wright Brothers made history, is now a global industry dominated by a dozen firms, at least half of which make good profits. Yet commercial aviation consists of 267 international carriers and another 500-plus domestic ones. The world's biggest carrier, American Airlines, has barely 7% of the global market, whereas the world's biggest carmaker,

General Motors, has (with its associated firms) about a quarter of the world's automobile market.

Aviation has been incompletely deregulated, and in only two markets: America and Europe. Everywhere else deals between governments dictate who flies under what rules. These aim to preserve state-owned national flag-carriers, run for prestige rather than profit. And numerous restrictions on foreign ownership impede cross-border airline mergers.

In America, the big network carriers face barriers to exit, which have kept their route networks too large. Trade unions resisting job cuts and Congressmen opposing route closures in their territory conspire to block change. Airlines dominate their home hub airports, putting pressure on municipal owners to keep out competitors. It is as if GM could get Toyota vehicles banned in Michigan.

In Europe, liberalisation is limited by bilateral deals that prevent, for instance, British Airways (BA) flying to America from Frankfurt or Paris, or Lufthansa offering transatlantic flights from London's Heathrow. To use the car industry analogy, it is as if only Renaults were allowed to drive on French motorways. So Europe continues with 23 flag carriers, whereas half a dozen more muscular airlines might suffice. Most analysts think that Europe will soon have only three big carriers with global networks—BA, Air France and Lufthansa. Were aviation a more rational business, there would be a handful of global airlines based in America, with another five or six in Europe and Asia.

In airlines, the optimists are those who think that things are now so bad that the industry has no option but to evolve. Frederick Reid, president of Delta Air Lines, said earlier this year that events since the September 11th attacks are the equivalent of a meteor strike, changing the climate, creating a sort of nuclear winter and leading to a “compressed evolutionary cycle”. So how, looking on the bright side, might the industry look after five years of accelerated development?

The two big forces for change, predating September 11th, are the advance of low-cost carriers (LCCs) and the greater transparency of fares provided by the internet. Neither will go away. So big airlines will no longer be able to gouge business travellers as they did in the late 1990s. In Europe, Ray Webster, the chief executive of easyJet, the biggest LCC, reckons that LCCs will grab half the European market, up from under 10% today, by 2010.

In America, the conventional wisdom has been that LCCs would remain at around 25% of the market. Most LCCs have a business model based on point-to-point connections between cities, flying out of cheaper secondary airports. Network carriers consolidate passengers at hubs fed by spokes linking them to smaller markets. LCCs face a bigger revenue risk with their point-to-point service, but they reduce it by offering very low fares and flying full aircraft. Their simple networks do not, for instance, involve keeping expensive planes sitting on the tarmac at a hub to provide connections. So LCCs get 50% more flying hours per day out of their aircraft than conventional carriers.

Now the two models are starting to blur. Network carriers are learning from LCCs to use internet bookings to cut distribution costs. They also now imitate their dynamic pricing, selling cheap seats early and raising the price as each flight fills up. But the LCCs, notably AirTran (formerly the much-derided ValuJet) and JetBlue, two of the more enterprising young airlines in America, are embracing aspects of the network-carrier model. AirTran, for instance, offers a separate business cabin (for a $35 supplement). AirTran, JetBlue and Southwest Airlines are also starting to offer transcontinental services in America, moving into a market dominated by the network carriers. So the LCCs could capture half of the market in America, too.

On a wider international front, the biggest change may come within a year, when the European Union takes over from member states responsibility for striking air traffic deals. At that point, there will be direct negotiations between the giant European and American markets over full liberalisation, including mutually unrestricted access. Carriers such as United in America and BA in Britain are already lobbying for this, hoping to create a sort of transatlantic common aviation market. The prize for the Americans would be the demise of uneconomic state-owned flag carriers in Europe, which distort competition across the Atlantic. For the Europeans, it would be access to the American market—some 50% of global air travel.

Along with that ought to come the abolition of restrictions on foreign ownership. And if Europe and America pool their air markets, the rest of the world may have no choicer but to do likewise. Mergers might lead to the creation of a dozen or so global carriers, fierce rivals yet profitable: not unlike in the car industry. In short, there would be a true globalisation of the industry that was midwife to globalisation. And the pessimistic scenario? More losses.

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Hong Kong and America

Keeping out Li Ka-shing

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A controversial takeover

Reuters

Scary Mr Li

PEOPLE in his home town, Hong Kong, call Li Ka-shing “superman” for his stunning business success. But America's government apparently considers him a potential threat. Though Mr Li, like his homeland, is ultra-capitalist, he does show up in lots of group photos with Beijing's Communist leaders, and Hong Kong is after all part of China again. It seemed so suspicious to an American government committee reviewing Mr Li's role in a proposed takeover of Global Crossing, a bankrupt American fibre-optic cable operator, that it pondered the case for 30 days, before announcing that it would keep pondering it for another 45. Mr Li is a busy man. On April 30th, he dropped his offer.

For Mr Li, this was a case of déjà vu. In 1999, even before terrorist attacks raised America's national temperature, several Republicans in Congress railed against Mr Li's business interests in the Panama Canal. Mr Li's flagship company, Hutchison Whampoa, is, among many other things, the world's largest private port operator, and it runs berths on both ends of the canal. Trent Lott, then Senate majority leader, called Hutchison “an arm of the People's Liberation Army”. To Asians, this sounded about as appropriate as Mr Lott's praise of Strom Thurmond's segregationist views rang to Americans last year.

Naturally, Mr Li cultivates what the Chinese call “guanxi”, or connections, in mainland China. On the whole, these seem to pay off—he managed, for instance, to get one of the choicest real-estate sites in all of China, just off Tiananmen Square. But Mr Li has pulled such stunts in Britain, Canada, and all sorts of places. Throughout his career, Mr Li has stayed surprisingly apolitical, given his influence.

Without his offer, Global Crossing could now go to Singapore Technologies Telemedia, with whom Hutchison had jointly bid $250m for a 61.5% stake. It is itself not uncontroversial, being owned by the government of Singapore. But Singapore has become one of President Bush's darlings for its staunch support in the war against terrorism.

Another possibility is to sell Global Crossing to IDT, a very American company run by a former Republican congressman, James Courter, who this week stated that “having critical US telecommunications assets in a foreign and communist-controlled country poses grave national security concerns for the US.” IDT has been buying other distressed telecoms companies, and Global Crossing would make a nice addition.

Mr Li is unlikely still to be thinking about this little setback. He continues to do well in electricity, property, oil, retailing, ports, and telecommunications. His biggest passion these days is third-generation mobile telephony, on whose success Hutchison is betting more than any other company in the world. Still, this episode might make for jolly cocktail-party banter next time he is in Beijing.

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Online music

How to pay the piper

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As lawsuits fly, a new service offers a simple way to pay for music online

SINCE Napster arrived in 1999 to pioneer the unfettered exchange of music files over the internet, the record industry has responded with a two-pronged strategy. It has done its best to stop illegal file-swapping in the courts. And it has backed several subscription-based online music services, to provide a legal alternative to piracy. So far, neither approach has had much impact. But the events of the past few days may prove a turning point for online music, in the courts and in the market.

On the face of it, the legal battle is going just as badly as ever. Napster is gone, having been killed last year by a lawsuit launched by the music industry's "big five" record companies. But KaZaA, Grokster and other file-swapping services that have sprung up in its place are now even more popular than Napster was in its heyday, and are proving much harder to shut down. New albums by Madonna, Radiohead and others are available online long before their official release; last week Madonna even resorted to flooding file-sharing services with expletive-carrying bogus files in an attempt to confuse pirates and boost sales of her new album, "American Life". Hackers promptly posted a free copy of the album on her website.

Napster lost in the courts because of a fatal flaw: it used central directory computers to keep track of the music each user was making available online so that other users could find what they wanted fast. Its parent company, which maintained these computers, was found guilty of "contributory infringement" of copyright. Its successors have avoided relying on a central directory computer. Instead, requests for a particular file are passed from one user's computer to another. This makes searching slower and less reliable, but lets the firms that make and distribute such programs (and profit by selling on-screen advertising) argue that they cannot be held responsible for the actions of their users. On April 25th, a federal judge in Los Angeles agreed, ruling that the firms behind Grokster and Morpheus, two popular file-swapping programs, were not guilty of contributory infringement, just as makers of video recorders are not responsible for the use of such machines for piracy.

This was a setback, but the record companies are having more luck trying to hit file-swapping networks in another way: by targeting users directly. On April 24th, another federal judge upheld a ruling in a test case that would require internet-access providers to reveal the identities of subscribers engaging in file-swapping when ordered to do so by a court. Verizon, an American telecoms firm that has so far refused to reveal the identities of two of its subscribers on privacy grounds, says it will appeal. The record industry aims to establish a precedent, so that it can force access providers to disconnect subscribers who are trading copyrighted material without having to go to court every time.

Even if it fails, the music industry has been quietly stepping up other efforts to pursue individuals by legal means—a risky strategy that could end up hardening some consumers' already-resentful attitude towards the record industry. On April 29th, the Recording Industry Association of America began sending messages to users of file-swapping programs who appear to be offering copyrighted music for download, warning them that they face possible legal action. The industry has also been clamping down on universities, asking them to warn students who use computers on campus of their criminal liability if they download music, and to wipe out illegally stored files.

So much for the stick. What of the carrot? Despite industry backing for several subscription-based online music services, such as Rhapsody, pressplay and MusicNet, response has been tepid. Lee Black, an analyst at Jupiter Research, estimates that such services have topped out at around 350,000 subscribers, compared with tens of millions of file-swappers. The appeal of subscription-based music services is limited for two main reasons. Rather than buy music outright, as they do on CD, users merely rent it for the duration of their subscriptions. And whereas a track on a CD (or downloaded from a file-swapping service) can be easily transferred on to a portable music player, or "burned" on to another CD, such

transfers are either prohibited by online music services, or cost extra.

So the launch on April 28th of a new online music service by Apple, a computer maker, could be a big step forward. The new service, called iTunes Music Store, rejects monthly subscriptions for a simpler model: each track from its 200,000-track library costs $0.99. Once purchased and downloaded, a track can be copied on to as many as three computers, burned on to CDs, and transferred on to Apple's popular iPod portable music-players. There is no need to buy an entire album just for one or two tracks. And Apple's boss, Steve Jobs, hopes that because there is no subscription fee purchasing a track will become an “impulse buy”. Many people, he observes, happily spend $3 on a cup of coffee.

So far, the new service is available only in America, to users of Apple's Macintosh machines, which account for under 5% of personal computers. A version of the service for PCs running Microsoft Windows is planned for later this year. In effect, Mac users are acting as guinea pigs for a new way of selling music online. If it proves popular, the other paid-for online services will no doubt demand the same licensing terms from the record companies, and follow Apple's lead. Rumours that Apple would buy Universal, the biggest record company, have proved unfounded. Yet just as Apple pioneered the graphical interface in the 1980s, it could now blaze a trail for the music industry. If, that is, it can beat a free alternative...

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Oil in Nigeria

Another day at the office

May 1st 2003 | LAGOS
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Kidnapping is just a cost of doing business

THE strikers' demands were quite reasonable. They said they wanted to be ferried to work by helicopter each day, rather than by boat. And they demanded the reinstatement of five colleagues who had been sacked for alleged embezzlement. The methods they used to press these claims were normal, too, for the Niger delta. They kidnapped nearly 100 expatriate workers on four oil rigs, which they reportedly threatened to blow up if the navy tried to storm them.

Oil firms in Nigeria are used to this sort of thing. Ethnic militants often kidnap their staff and demand money, or jobs for their cousins. It is an unusual way of trying to impress potential employers, but it works. Oil firms really do hire people at gunpoint, or at least pay them to go away. Happily, the kidnappers rarely kill their captives. In the early 1990s, when they were motivated more by politics, their victims were treated as honoured guests, with air-conditioned huts, the best pepper soup and more.

Two oddities about this week's stand-off were that the kidnappers were employees, rather than ethnic militants, and that the firm involved, Transocean, an American drilling contractor, has (so far) declined to be blackmailed. This is principled: by paying up, other firms give kidnappers an incentive. But it is a risky strategy. As *The Economist* went to press, the Nigerian navy reportedly boarded the rigs.

All in all, Nigeria is a tough place to work. Expats demand higher pay to live there—though perhaps no more so than in, say, Colombia. Shell, the largest operator in Nigeria, said this week that 10% of national oil output is lost to thieves, who puncture pipes to get at the contents. But these expenses are bearable. It still costs under $5 a barrel to pump Nigerian crude, so the oil firms will stay.

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Corporate governance

Killing capitalism?

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A leading French capitalist worries about the system that made him rich

AP

France's godfather of capitalism

DEPENDING on whom you ask, Claude Bébéar either is, or wants to be, the godfather of French business and finance. Founder and chairman of AXA, France's biggest insurer, Mr Bébéar has been a quintessential capitalist, using numerous acquisitions to turn an unknown regional firm into a global giant. His eyes sparkle with commitment to the jockeying and scheming of the corporate world. Surely it was his covert influence that led to the ousting last year of Jean-Marie Messier, Vivendi Universal's controversial boss? Mr Messier certainly thinks so—he detests Mr Bébéar and the cosy club he represents.

And was not, according to the rumour-mill, Mr Bébéar also quietly campaigning to remove Jean-Pierre Tirouflet, boss of Rhodia, another embattled French firm? On April 29th, Mr Tirouflet survived an effort by rebellious shareholders to unseat him. Mr Bébéar took the unusual step of denying any involvement. But just the mention of his name had raised the profile of the minority shareholders who wanted Mr Tirouflet out. Like it or not—and he mostly likes it—Mr Bébéar's has become a talismanic name. Now he wants to use his influence to challenge the very system that made him famous. He thinks the capitalist system is in danger of imploding, and has published a book, “Ils vont tuer le capitalisme” (Editions Plon), to explain why.

Some of what he says is far from original. Financial markets and the real economy have disconnected, he says. Share prices no longer reflect true values as they are too volatile. Analysts follow ratios like sheep, and have sold their independence to their corporate-finance colleagues.

As for quarterly reporting, the less said the better. Porsche, a German car maker, has been arguing fiercely with the Deutsche Börse over its plan for compulsory quarterly reports from listed firms. Porsche says such reports are inconsistent with how it wants to present its long-term strategy. Mr Bébéar would approve. Such reports encourage false accounting and a dishonest culture, he says, pointing a finger, as the French are wont to do, at America.

If Mr Bébéar had painted only this bleak picture, then he might have been ignored as merely another doomsayer. But he has gone further, suggesting restoratives for the capitalist system. At the heart of today's malaise, he argues, is the fact that shareholders have forgotten that, as well as rights, they also

have duties.

To remedy this, Mr Bébéar proposes that voting by shareholders should be compulsory. More boldly, he wants to scrap the principle of equal treatment of shareholders (a cynic might argue that it is often ignored in Europe anyway) in favour of a system that rewards investors for holding shares over time. Thus, an investor who owns a share for, say, two years, will have more voting rights than one who bought yesterday. And the dividend received would rise with the length of the investment. After a decade, it might be 50% higher than on a newly purchased share.

With full disclosure of such arrangements, financial markets could set prices accordingly. For example, in France there are limited companies, but there is also a company structure under which shareholders do not appoint the management: Michelin, a tyre-maker, is an instance. This structure means that its shares trade at a discount, but investors know why and can choose whether or not to buy. Mr Bébéar foresees a plethora of such arrangements in future—including, presumably, some that would actually increase a firm's value—provided that the market has the will to change today's flawed system.

The logic is that such reforms would become self-reinforcing. An investor with an enhanced dividend would be reluctant to lose it by selling, but more inclined to intervene in a company and, says Mr Bébéar, thereby fulfil his ownership duties. “As investors, we need to re-think the nature of equity,” says Mr Bébéar.

Mr Bébéar also thinks it has been a mistake to limit the role of auditors to looking at numbers. Acting as a check and balance to management, the auditors should comment on a firm's strategy and the status of its assets. Give them the authority to question what they see and an obligation to report to investors, and you might avoid disasters such as Enron—or Vivendi.

How realistic is all of this? In some cases, reform would require new laws or the scrapping of old ones. Shareholders would have to agree: how willingly would they accept greater rewards for those who held shares longest? Companies would have to be prepared to try something new. But firms can be as sheep-like as those who analyse them. Mr Bébéar hints that a few pioneering firms may have to break ranks. Presumably, then, it will be worth keeping an eye on AXA, where Mr Bébéar has scope to put his ideas into practice.

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Pay for chief executives

Is that enough?

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At last, shareholders are revolting

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FOR years, it seems, shareholders have bought the argument that top-quartile performance meant top-quartile pay for the chief executive. Now, plenty of bottom-quartile American companies still seem to be richly rewarding the boss, and shareholders have been protesting (in Britain as well as America, see article). According to the Investor Responsibility Research Centre, this year a record 275 shareholder proposals are critical of bosses' pay.

While the value of many companies has contracted, bosses' pay packets have not. Pearl Meyer, a large pay consultancy, surveyed the compensation of chief executives of 200 American firms that filed their results for 2002 earlier this year. Median pay for chief executives—a better guide than average pay—rose by 18% over 2001. That figure covers all compensation except the theoretical value of stock options. Add that in, and median compensation rose by only 3%. But it still grew, even in a year of falling share prices.

Last week, compensation arrangements claimed a rare victim: Don Carty, head of American Airlines, resigned after failing to tell its beleaguered unions that the company made a $41m pre-tax payment last October to a trust fund to protect the pensions of 45 executives if the company went bust. Last year Delta, another floundering airline, put $25.5m in a protected pension trust for Leo Mullin, its chief executive, and 32 other executives. Lucky Mr Mullin was credited for 22 years of service, entitling him to a much larger pension. Again, the aim was clearly to make sure that the chaps at the top have lifebelts if the ship sinks.

Increasingly, bosses' pay is structured to protect them from risk. There is, points out Paul Reilly, head of Korn Ferry International, a growing demand for cash rather than stock options: in 2002, 84% of chief executives of a sample of the top 1,000 American firms received options, down from 90% in 2001. Pensions are emerging as the perk of choice. “Pensions, remember, are guaranteed pay,” says Steven Hall of Pearl Meyer—especially when they are put in special trusts that are Chapter 11-proof. “There is an attempt to take the risk out of pay programmes.”

Some would like to see the risk redefined rather than removed. Peter Kontes, co-founder of Marakon, a consultancy, argues that chief executives' basic annual salaries should be higher, and bonuses paid rarely, and only for exceptional performance. Simon Garrett of Hay Group, a pay consultancy, argues that incentives linked to share values should go only to two or three top executives, who set company strategy. Those lower down the list should get cash rewards instead.

Maybe. But this all seems terribly similar to what happened in the last prolonged bear market, and might herald exactly the sort of easily manipulable remuneration schemes that made share options seem such a brilliant idea in the first place.

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Space tourism

G-whiz

May 1st 2003
From The Economist print edition

The first commercial zero-gravity flights may soon take off

TAKING a flight on an aircraft that repeatedly plummets to the earth in a death-defying dive is not everyone's idea of fun. But it is the only way to experience the feeling of weightlessness that astronauts get when they travel into space—short of boldly going there too. Alas, adrenaline addicts have just one way to experience zero gravity—travel to Russia and take a trip on a modified, government-owned airforce Ilyushin-76 plane.

This could soon change. This summer, if all goes to plan, the Federal Aviation Administration (FAA) will grant the first commercial licence to an aircraft that can take tourists on “parabolic flights” out of American cities. The firm, er, floating the idea is the Zero Gravity Corporation—and one of the people behind it is Peter Diamandis, a pioneer in the embryonic “spacetourism” business and co-founder of a travel company called Space Adventures.

For the past five years, Dr Diamandis's team has been testing a Boeing 727 for parabolic flights. The final step for FAA approval is nearing, when the craft will undergo training and demonstration flights.

Zero Gravity will work with an unnamed freight airline that now uses its aircraft only at night. The main modification is the addition of lots of padding—essential when, in free fall, every direction is up.

It will probably cost around $4,000 a head for a full day's astronaut-training experience. The highlight will be a two-hour flight in which 25 customers at a time will enjoy about 20 dives, each providing 30 seconds of zero gravity.

Zero Gravity says that the greatest interest is from firms wanting to reward their employees with something more interesting than a round of golf. There is also interest in using the aircraft to film for TV and movies, and for experiments and testing satellite components in zero gravity—especially while the space shuttle is grounded.

Flights on the Russian aircraft have attracted passengers ranging from scientists to zero-gravity dancers. The possibilities for things to do in zero gravity are endless. Arthur C. Clarke, a master sci-fi author, once speculated that weightlessness would inspire new forms of erotica, and “Moonraker”, a James Bond film, featured a zero-gravity sex scene.

Mr Diamandis is reluctant to discuss the potential for his new enterprise to attract those who find the mile-high club too tame—and don't worry that all those sudden dives might bring on a nasty headache. But he would be happy for couples to hire the aircraft. The cost? A private ride on a parabolic Boeing 727 would cost $85,000. Alas, he has no plans to accept air miles.

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Sony

Surprise

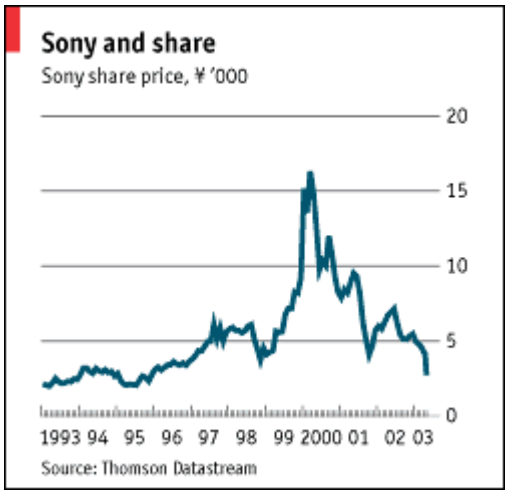
May 1st 2003 | TOKYO
From The Economist print edition

Dismal results at Japan's top electronics firm have stunned investors

Get article background

IN CONSUMER electronics, it is fine to show people something smaller than they expect—as long as it is a clever new portable device for listening to music or taking pictures. It is not a good idea, however, to try this with profits. When Sony announced lower-than-expected earnings on April 24th, investors were most unpleasantly surprised. Japan's stockmarket continued to reel early this week, as investors tried to work out how the firm could have done so badly with so little warning. Although Sony has long been one of Japan's most successful firms, its core consumer-electronics business, which accounts for two-thirds of sales, is in trouble. Its shambolic earnings release reinforced the impression that the firm's managers, starting with Nobuyuki Idei, the chief executive, are still not on top of the problem.

Sony's ¥115.5 billion ($948m) net profit for its latest fiscal year was better than the year before, but more than a third lower than the firm had said it expected. The weak result was due largely to a net loss of ¥111 billion and a 12% drop in sales in the most recent quarter. Nor does Sony expect things to get better soon. After taking ¥100 billion of restructuring charges last year, it plans to take another ¥140 billion this year. Although some of last year's charges relate to Sony's music business, most of the overhaul is aimed at its electronics arm. Japan's high cost base, plus growing competition, are chomping away at the unit's profit margins, which have now fallen below 1%.



Mr Idei hopes to cure this by moving production out of Japan and shutting plants. But it will take more than that to restore the group's margins to 10% by 2006, as Mr Idei promises. Worse, the two units that have kept Sony afloat lately also face a tough year. Shipments of its PlayStation and PS2 game consoles are likely to fall, and it will be a couple of years before its third-generation consoles hit the market. Nor does Sony expect its film business to do as well as last year, when “Spider-Man” and the sequel to “Men in Black” boosted profits.

All of this should keep Sony's seven proposed new board members busy. They include Carlos Ghosn, who won fame by cutting costs and reviving Nissan after Renault, a French car maker, took it over; and Yoshihiko Miyauchi, the outspoken head of Orix, a Japanese leasing company. Unfortunately for Mr Idei, the only way these people can begin to help is by hitting him with the same stinging questions that shocked investors are asking.

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Face value

The first casualty of war

May 1st 2003
From The Economist print edition

When the BBC's Greg Dyke talks about truth, you should smell a rat

PA

Get article background

GREG DYKE, head of the BBC, declares himself “shocked” (shocked!) by the American news networks' coverage of the Iraq war. In a pointed speech in London last week, he contrasted the “gung-ho patriotism” and “narrow, pro-American agenda” of American TV news with what he described as “the drive for accurate and impartial reporting” which is “in the DNA” of the BBC. In a speech liberally sprinkled with self-congratulatory references to the corporation's “impartiality”, “balance” and “independence”, Mr Dyke presented the BBC as a rock of objectivity in a commercial, Americanised sea of uncritical jingoism. For those pro-war Americans who dubbed the Beeb the “Baghdad Broadcasting Corporation”, this was all rather perplexing.

Certainly, the network he singled out for criticism, Fox News, owned by Rupert Murdoch's News Corp, may offend genteel British tastes. The Stars and Stripes in the corner of the screen, the unapologetic cheerleading for “our guys”, the loose control the anchors have over the pitch of their voice—not to mention all the big hair—is a far cry from the slightly scruffy, sceptical Brits who tend to deliver the BBC's news bulletins.

Yet surely the war in Iraq, with its unprecedented real-time delivery of front-line action into the living room, has punctured the idea that 24-hour television news can supply instant objectivity. Anchors, in a vain attempt to provide context for the random collection of eye-witness reports, put impossible demands on correspondents, especially those “embedded” with soldiers. Anchor to reporter standing in dust storm in desert, wearing protective goggles: “What's your overall view of how the war is going?” This was raw, undigested news which every station had a hard time cooking into sensible analysis.

Mr Dyke largely ignored the subtle, tricky issues this raises. Instead, quoting advice given to the BBC's journalists, he simply said that: “Our audiences should have confidence that they are being told the truth.” Plainly, any news organisation should aspire to reach as close an approximation of “truth” as is ever possible. But it is often fiendishly hard for reporters to do so. This war, as wars do, compromised journalists at every turn. Were embeds free to tell the “truth”? Did Central Command in Qatar tell the “truth”? Did minders in Baghdad allow reporters there to report the “truth”? When CNN's Eason Jordan, its chief news executive, confessed that, to protect his staff in Baghdad, his network had withheld

information about murder and torture by Saddam Hussein's regime during the 1990s, what sort of “truth” had CNN been reporting about Iraq all those years?

But suppose for a moment that Mr Dyke's claim to be reporting the truth is fair. Is the goal of objectivity a sensible commercial strategy? Mr Dyke argues that the American TV news networks, which “wrapped themselves in the American flag and swapped impartiality for patriotism”, misjudged the market. They have undermined their credibility with viewers, and will lose share as a result. Mr Dyke, whose background is in commercial TV and who brought Roland Rat, an irritating puppet rodent, to British breakfast TV, regards this as an export opportunity for the BBC: to occupy the niche deserted by the American news outlets. The growing popularity during the war of the BBC News website and of BBC World TV news, he argues, shows that there is an appetite for a trusted brand of independent news.

Judging by the past year or so, in the highly competitive American TV news market where four big broadcast networks jostle with three big 24-hour cable news channels, it is angled, high-octane, opinionated news—not sober objectivity—that sells best. Fox News is beating CNN hands down in the ratings. Fox argues that this has nothing to do with a less objective view—the channel's slogan is “We report. You decide.”—but a less staid reporting style, albeit with a conservative twist. At the very least, in a competitive news market such as America's, no network will thrive for long by reporting readily refutable untruths. Mr Dyke may insist that patriotism and journalism should never mix, but, within limits, that may be what Fox's viewers want.

Arguably, a fiercely competitive news market encourages such segmentation. Britain's newspaper market, for instance, which is as competitive as America's TV news market, has also sharpened the political leanings of its national titles—though, in Britain, the left-wing *Guardian* boosted sales the most in percentage terms during the war. And even if Mr Dyke is right to spot a lucrative niche for the BBC in America, that may be because some consumers want an offshore, international—maybe even anti-American—spin to their news, not because the BBC is necessarily more truthful.

Economical with the truth

Which prompts a cynical thought: might Mr Dyke's concern with truth owe quite a lot to economics? Thanks partly to the rise of Fox's sister station, Sky News, British TV news is more competitive than it was when the mighty BBC towered over everybody else. But it is also far more regulated than American TV news. Mr Dyke fears that, with a bill that would open Britain's top commercial TV station to American ownership currently before Parliament, British news will “become Americanised”.

In short, it may have been business strategy as much as shock that inspired Mr Dyke's attack on American TV news. The man who embodies the world's best known public-service corporation may simply have been making a sales pitch for the American market. He may also have been making another self-serving case, addressing a British constituency that must decide whether in 2006 to renew the charter giving the BBC its generous licence fee (a tax on having a TV set). Britons—or, at least, politically influential ones—may be more sympathetic to the idea of lavishing public money on an institution if it is seen as a bulwark against the ghastly Americanisation of the British airwaves.

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Wall Street

Unsettling

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Reuters

After months of bargaining, the investigation into investment banks is over

IT HAD, acknowledged one of the participants, all the elements of a bad awards ceremony: pious, self-congratulatory speeches and a lack of surprise. A year-long probe into how Wall Street's leading firms underwrote and recommended lousy stocks during the boom was officially closed on April 28th, with a packed press conference in the basement of the Securities and Exchange Commission (SEC) in Washington.

Hundreds of stocks had collapsed; hundreds of billions of dollars had been lost. Someone had to be held accountable. Everyone already knew who would be blamed and what their punishment would be, thanks to a mixture of announcements and leaks. To settle charges that, to varying degrees, they had either touted rotten shares or in effect bribed company bosses to gain investment-banking fees, ten Wall Street firms agreed to pay a total of $1.4 billion in fines, “disgorgement” of ill-gotten profits and payments to support independent research and investor education (see table). Two more banks are still haggling with regulators.

The reckoning

Payments in Wall Street settlement, $m

	Penalty	Disgorgement	Independent research	Investor education	Total
Bear Stearns	25	25	25	5	**80**
Citigroup	150	150	75	25	**400**
Credit Suisse First Boston	75	75	50	0	**200**
Goldman Sachs	25	25	50	10	**110**
J.P. Morgan	25	25	25	5	**80**
Lehman Brothers	25	25	25	5	**80**
Merrill Lynch	100*	0	75	25	**200**
Morgan Stanley	25	25	75	0	**125**
Piper Jaffray	12.5	12.5	7.5	0	**32.5**
UBS Warburg	25	25	25	5	**80**
Total	**487.5**	**387.5**	**432.5**	**80**	**1,387.5**

Source: Securities and Exchange Commission

*Payment made in prior settlement with state regulators

The investment banks will also adopt new operating procedures intended to separate the function of research (recommending shares) from investment banking (underwriting them). In future, analysts' pay will be determined by the quality of their stock-picking, and their reports will note their employers' conflicts of interest. Firms will disclose the success of their research. “Spinning”, or the provision of shares in hot initial public offerings (IPOs) to executives whose firms are potential clients, will not happen again (when, that is, the IPO market eventually revives). Regulators believe that the new procedures will restore fairness, and even integrity, to financial markets.

No one from the banks squeezed into the SEC's basement to hear the verdict, but Wall Street may be just as happy as its regulators. The penalties and disgorgement charges amount only to three-fifths of the cost of the settlement. The rest may be met by insurers, or be tax-deductible. Even if not, the full bill is equivalent to just a few days' collective profits, and is a tiny percentage of what was earned from underwriting during the boom. And if the new procedures are costly, then the big firms can content themselves with the thought that they all carry the same burden. Better still, none of them has had to admit any guilt. The market has given a vote of confidence: the shares of the investment banks covered by the agreement have all done brilliantly in the past few weeks.

Senior executives at Wall Street firms have also been spared by the settlement, notwithstanding remarks by Eliot Spitzer, attorney-general of New York state, that malfeasance went well up the corporate food chain. The two self-regulatory organisations that are primarily responsible for the conduct of the big banks, the National Association of Securities Dealers and the New York Stock Exchange, were also spared censure, even though they may have deserved it. During the boom of the 1990s, both benefited from the torrent of trading and new listings. They donned their regulatory hats and joined in the investigation only after the bust was at hand and the damage done. Mr Spitzer made the running, followed by other state attorneys-general and the SEC.

Left to carry the can for all the bad advice and all the bad deals were just two equity analysts: Henry Blodget, once an internet analyst at Merrill Lynch, and Jack Grubman, formerly a telecoms guru at Salomon Smith Barney, Citigroup's investment-banking arm. Each has been banned from the securities industry for life. Mr Blodget will pay $4m in fines and Mr Grubman $15m. A separate investigation by federal prosecutors in New York has now targeted a third person, Frank Quattrone, formerly an investment banker with Credit Suisse First Boston (CSFB). Although they were influential in their fields, whatever went on during the boom was hardly the fault of just three men.

Having settled with the regulators, Wall Street firms can now expect plaintiff lawyers to start filing civil suits. That the banks did not have to admit guilt in this week's settlement may help them in those battles. The SEC considers this standard practice, but juries in future cases may interpret it as a lack of, well, guilt. Indeed Jack Coffee, a professor at Columbia Law School, suggests that the banks actively sought a settlement with the regulators, so that they could assure investors that the evident problems had been cured and the conflicts of interest had been banished.

Enter the lawyers

Nonetheless, the pile of documents accompanying the settlement will be required reading for plaintiff lawyers. Accusations of impropriety against J.P. Morgan, CSFB and Citigroup have already been widely aired. The fresh disclosures show that their competitors have problems as well. An analyst at Goldman Sachs complained that he could not lower his ratings on AT&T and WorldCom because of investment-banking ties. At Piper Jaffray, a junior analyst said a company should be rated a “buy” because of a banking relationship, but would be “neutral” without one. At Bear Stearns, an analyst said, “The artificial buy rating on a stock makes me look bad.” The list goes on.

One of the most interesting allegations buried in the legal documents concerns the use by investment banks of underwriting fees to subsidise research by other investment banks in an underwriting syndicate at the request of the company issuing shares. Because investors view the initiation of research as an encouraging sign, this would, other things being equal, boost the company's share price. By law, payments of this sort should be disclosed in the offering document. According to regulators, they were not. The worst offender was Morgan Stanley, which, according to the settlement, paid $3m to 25 banks in 12 offerings between 1999 and 2001.

This week's settlement leaves many questions unanswered. One is the rationale for the scale of the penalties and other payments. The $1.4 billion is trumpeted by regulators as one of the largest ever, yet

its economic underpinnings are about as sound as those of analysts' loopy buy recommendations during the boom. It was based on the $100m fine levied last June on Merrill Lynch. The justification for this was that it looked bigger than past civil penalties in the securities industry.

Nor is it clear how the money will be spent. More than $430m will be allotted to independent research, but no one knows what such research might be. Another $80m is to be spent on investor education. Again, no one knows what this means, or how the spending will be administered. Most complex of all, the settlement includes a fund of $387.5m for investor restitution. Even if this is reserved for losses on stocks mentioned in the complaint, dividing the money fairly looks impossible. Investors lost billions of dollars on these stocks alone.

The wisest course for investors may be to consider their losses an effective, if expensive, form of education. Next time they should use the only truly independent research available: their own.

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Credit and debit cards

Plastic pricing

May 1st 2003
From The Economist print edition

Visa and MasterCard settle out of court with American retailers

A JURY trial due to start in New York this week was settled out of court when Visa and MasterCard, the world's two biggest credit-card associations, agreed to pay $3 billion in compensation to retailers and to lower their charges for certain payments. That ended a class action led by Wal-Mart, on behalf of nearly 5m American retailers. Visa will pay $2 billion and MasterCard $1 billion over the next ten years. The plaintiffs' real victory, however, was to force Visa and MasterCard to lower their fees for offline debits.

The retailers claim that the credit-card associations have been forcing them to give customers complete freedom to choose whether they use credit or debit cards, and whether they verify their identities electronically or with their signatures. This may sound harmless, but the retailers say that one method of payment has cost them collectively billions of dollars a year in unnecessarily high charges—which they have passed on to their customers. The American public has been blissfully unaware of this hidden charge.

At issue were the so-called interchange fees that Visa and MasterCard levy from retailers, on behalf of issuing banks, every time one of their customers uses a debit or credit card. The safest and most efficient payment method, from the retailer's point of view, is a debit card combined with a PIN (personal identification number) punched by the customer into an online device at the point of sale. This transaction debits the customer's account instantly, and costs the retailer about 12 cents for a $100 purchase.

All other methods either involve customer credit or are less secure. For example, the customer can use an offline debit card, supplying a signature but no PIN. His account is debited after a day or so, and there is less certainty about the availability of funds (insufficient funds can land him with a surcharge) and protection from fraud. The Visa and MasterCard interchange fee for this service is around $1.50 for a $100 purchase.

Logically, retailers would prefer customers to use the online method at less than a tenth of the cost. But most customers have no idea that the services are differently priced, and Visa and MasterCard have not gone out of their way to enlighten them. In fact, the Wal-Mart plaintiffs argued, they did exactly the opposite: Visa and MasterCard conspired for years to steer customers towards the expensive service. Why else would there be such a dearth of PIN devices at checkouts in the United States? Only 28% of outlets have them, while across the border in Canada the level is between 54% and 70%.

There is worse. Back in 1997, according to evidence that Lloyd Constantine, Wal-Mart's lawyer, dug up, MasterCard apparently colluded with the more powerful Visa and shelved efforts to push its online Maestro card in America. At a rather theatrical hearing in January, Mr Constantine persuaded the presiding judge, John Gleeson, that Wal-Mart's case was mostly already won. MasterCard agreed to settle out of court on April 28th. The terms included dropping its insistence that all methods of payment be honoured, and a “substantial” reduction in the offline interchange fee starting in August.

As the bigger fish, Visa had more at stake and held out a day or two longer. It has around 80% of the offline debit payments market in America, while MasterCard has about 20%. Outside America, particularly in Britain, Austria and Switzerland, MasterCard has a growing share of online debit payments, thanks to Maestro. Perhaps, say pundits, MasterCard broke ranks and went for a settlement first because it saw a chance to get ahead while Visa was tied up in litigation.

Estimates of Visa's and MasterCard's liability, had the card associations lost in court and had punitive damages been awarded, ranged from $7 billion to many times that. Interchange charges for offline

payments have cost retailers perhaps $4 billion a year more than online payments would have done, say market sources. In the end, faced with the uncertain outcome of court action, the card companies were forced into what Visa called a “reasonable and responsible resolution”.

Competition authorities in Britain, acting against MasterCard, and in the European Union as a whole, against Visa, have tried to tackle the hidden levy embedded in interchange fees. Britain's Office of Fair Trading has asked MasterCard either to lower its fees or to come up with more arguments for why they should be so high. It is expected to issue a ruling this month. Visa was forced last year by the European Commission to lower its cross-border interchange fees for credit and offline debit cards. By 2007, they must match the French level of 0.7%, chosen by the European Commission as a benchmark, everywhere in the euro zone.

However, the Wal-Mart case, which had been brewing since 1996, shows how hard it is to prove that consumers are disadvantaged by hidden card charges. Behind Visa and MasterCard are thousands of banks, many of them members of both associations, which continue to make big profits from their share of interchange fees. They have used these profits to subsidise other services, such as free current accounts and credit cards' implicit offer of a month's free loan.

However, such perks are not transparent and tend to favour certain income groups at the expense of others. Customers may be reluctant to lose them, especially if the lower charges that retailers have won are not passed on in lower prices in shops. Nevertheless, if there is to be greater transparency in retail financial markets, the structure of costs and fees of what remains, in effect, a duopoly in plastic cards should be plain for all to see.

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Indian banks

Come and buy

May 1st 2003 | MUMBAI
From The Economist print edition

Foreigners are wary of buying their way into India's retail-banking market

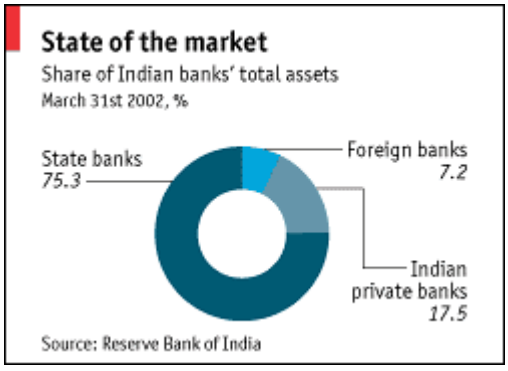
ON PAPER, at least, India's commercial-banking market is opening up to foreigners. In February Jaswant Singh, the finance minister, raised the limit on foreigners' stakes in private Indian banks from 49% to 74%. Foreign banks may now set up subsidiaries in India, not just branches. And in recent years the number of new branch licences issued annually has been more than the 12 India promised the World Trade Organisation.

Certain events might suggest—at first blush, at any rate—that foreign banks are eager to use their new freedom to buy Indian private banks. On April 23rd foreign investors led by Sabre Capital, a group of four ex-bankers including Rana Talwar, former head of Standard Chartered, a British bank, said they would pay around $27m for 48% of Centurion, a troubled private bank. Other foreign investors are also buying stakes in the bank. Mr Talwar, who is Indian, says that he sees his homeland as “the most promising market among emerging countries for retail financial services”.

Mr Talwar's strike follows last year's move by ING, a Dutch bank, to raise to 44% its stake in Vysya, a bank of which it had owned a small slice since 1996. The purchase has given ING a branch network to sell insurance, another newly deregulated market. The Dutch bank owns 26%, the maximum permitted for foreigners, in an insurance joint-venture with Vysya. It has not yet decided whether to increase its stake in the Indian bank further, as Mr Singh's new rules allow. On top of this, foreign private-equity investors have bought into a few fast-growing private banks with high technological skills, launched in the mid-1990s as showcases for India's financial deregulation.

Despite all these positive signs, there is little enthusiasm among foreigners for buying India's private retail banks. It took Centurion more than a year to find a buyer; several possible partners rejected it. Niall Booker, who heads HSBC in India, says that, for all the excitement around retail banking, banks made most of their profit last year on the wholesale side. A large portion of the population is simply not bankable, he says. Competition is fierce, particularly from local private banks such as HDFC and ICICI, in the booming business of home, car and consumer loans.

Indeed, some foreign banks have left the country. Fewer than 40 remain in India. Their share of total bank assets, currently 7.2%, is falling, in a market still dominated by the state (see chart). Those that remain might be thought to be likely buyers of Indian banks. Yet Citibank, HSBC and Standard Chartered—all in India for more than a century, and with fairly large retail networks—seem to have no pressing need to acquire a local bank. Established foreign banks have preferred to take over customers or businesses from other foreign banks that want to leave. Thus HSBC, in recent years, has acquired customers from France's BNP, Germany's Deutsche Bank and Japan's Bank of Tokyo-Mitsubishi. ABN Amro, a Dutch bank, took over Bank of America's retail business.



In any case, only around half a dozen of India's 30 private banks are worth buying. Most have poor assets, are controlled by an ethnic group or have only regional networks. The risk in buying an Indian bank, says Bart Hellemans, managing director of ING Vysya, lies in the difficulty of assessing the quality of its assets, customer data, contingent liabilities and distribution skills. Mr Talwar clearly has more faith in his ability to turn around Centurion than all the prospective buyers who looked at the books, shuddered and walked away. He believes he can put matters right within a year or so. Hopefully, he will have a happy homecoming.

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Munich Re

Changing the guard

May 1st 2003
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The world's top reinsurer is getting a new boss. Why not a new strategy too?

ALL change in Königinstrasse. This peaceful Munich street is home to both Allianz, one of the world's largest insurers, and Munich Re, the world's biggest reinsurer. Both have reputations for solidity and continuity that have lately been shaken by unusually hard times. Both are changing their bosses. On April 29th Henning Schulte-Noelle, chief executive of Allianz for 12 years, stepped aside for Michael Diekmann. The day before, Hans-Jürgen Schinzler, his counterpart at Munich Re since 1993, had said he would go at the end of the year.

Mr Schinzler is 62 and thus ripe for retirement by the standards of corporate Germany. Even so, the timing of his departure is probably connected to the state into which Munich Re has fallen. Last year the reinsurer made a profit of *euro*1.1 billion ($1 billion) only because it sold *euro*4.7 billion-worth of shares in its neighbour, Allianz. It lost *euro*2.2 billion in the fourth quarter. On April 30th Munich Re warned investors that it might have lost money again in the first quarter of 2003.

Under Mr Schinzler, the giant reinsurer has diversified into other fields: its ERGO subsidiary is one of Germany's biggest primary insurers, and it owns 25.7% of HypoVereinsbank (HVB), the country's second biggest bank, as well as one-tenth of Commerzbank. Reversing this diversification, and concentrating on reinsurance, might provide Munich Re with a way out of its troubles. Yet Nikolaus von Bomhard, Mr Schinzler's successor, does not yet sound like a man about to change course. He says he does not consider a new strategy necessary.

Granted, the main culprits for Munich Re's current woes are its exposure to equity markets, partly through its shareholdings in other insurers and banks, not its diversification. At the end of 2001 Munich Re had 33% of its assets in equities; now, it has less than 10%. Besides its stake in HVB, Munich Re owns one-fifth of Allianz. Both holdings have lost more than 75% of their value in the past three years. That said, Munich Re's activities in primary insurance are not profitable either. ERGO lost *euro*1.1 billion last year, thanks mainly to investment losses.

Munich Re intends to reduce its stake in Allianz to 15%. Michael Huttner of J. P. Morgan Chase thinks Munich Re should go much further, cutting its stakes in Allianz and HVB to 5%, as well as floating or selling ERGO. This would free perhaps *euro*8.6 billion to be redeployed to reinsurance.

“I would like them to do what Swiss Re did,” says Mr Huttner. In 1994 Swiss Re, Munich Re's arch-rival, reversed its ill-fated diversification strategy to concentrate on reinsurance. A new boss, Lukas Mühlemann, sold off all Swiss Re's non-reinsurance businesses. By December 1996 the share price had almost tripled.

The market for reinsurance is “hard” at the moment, with prices increasing and demand rising. Rates for reinsurance rose across the board by 14% last year, and conditions in reinsurance treaties, as the industry's contracts are called, have tightened. However, because of its weak balance sheet, Munich Re cannot take on as much new business as it would like to.

Munich Re has just raised *euro*3.4 billion in the capital markets. How could it raise more to finance the underwriting of more profitable reinsurance business? It could ask shareholders for cash, but that would hardly be welcome: Allianz, Munich Re's biggest shareholder, completed its own *euro*4.4 billion rights issue on April 30th. Or the reinsurer could sell something. Munich Re conceded this week that it might sell at least part of its stake in HVB. When Mr von Bomhard takes over in eight months' time, a strategic shift could already be under way.

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Euro-area economies

Summer cancelled

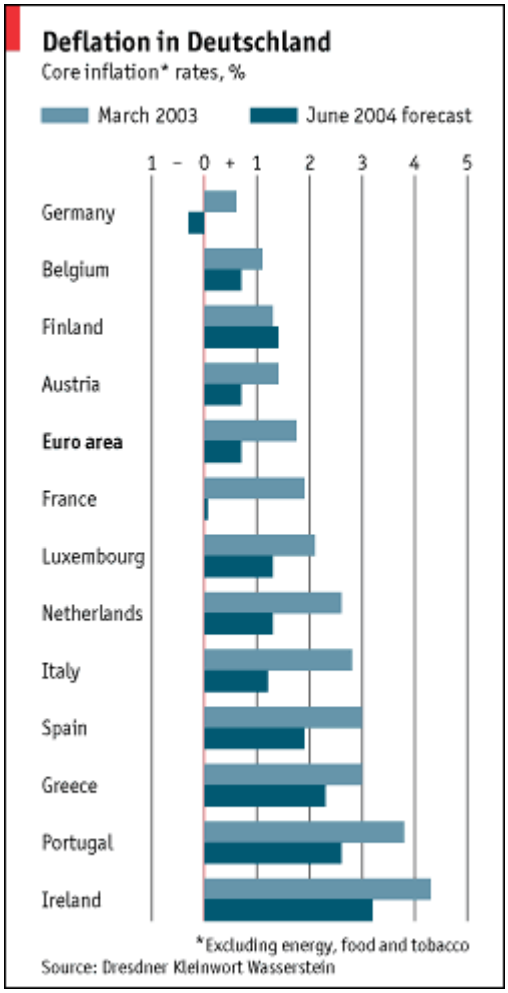
May 1st 2003
From The Economist print edition

The case for another cut in euro-area interest rates is overwhelming

THE European Central Bank is not one to cave in to calls for lower interest rates from market commentators and politicians. But what if those calls are obviously right? In March the bank disappointed many by cutting rates by a mere quarter-point to 2.5%. The ECB next meets on May 8th against an increasingly gloomy outlook for growth in the euro zone. Yet recent comments from ECB officials suggest that the bank is in no rush to cut again.

The euro area's economy grew by only 0.7% at an annual rate in the fourth quarter of 2002, and has begun this year sluggishly. Germany's Ifo survey of business confidence was worse than forecast in April, falling to levels normally seen when output is flat or falling. The German government has cut its growth forecast for this year to only 0.75%.

Over the past couple of years, while Germany's economy has been stuck in first gear, France's has motored along nicely. Now the French engine is sputtering too. France's GDP growth in the fourth quarter of last year has just been revised down, to show a decline of 0.3% at an annual rate. This year is looking no better. The INSEE survey of business confidence fell unexpectedly in April, to its lowest level for more than a year. Consumer confidence has also fallen sharply this year, to its lowest level since 1996. As a result, the French economy, like Germany's, may have suffered two consecutive quarters of declining GDP, satisfying the commonest definition of recession.



The standard response of ECB officials to demands for another interest-rate cut to spur growth is to claim that monetary policy is already extremely stimulative, because never since the second world war have rates been as low as they are now. But nominal interest rates are a poor measure of monetary tightness; a better test is the “Taylor rule”, devised by John Taylor, an American economist now at his country's Treasury. This calculates the appropriate real interest rate from the output gap (ie, the gap between potential and actual GDP) and the deviation of inflation from its target (in the euro area, 2% or less). Most estimates of the rule suggest that interest rates are broadly correct for the euro area as a whole.

However, this does not get the ECB off the hook. The first concern is that the central bank has reacted too slowly to the recent rise in the euro, which could seriously reduce future growth and inflation. This week the euro rose to a four-year high against the dollar, above $1.11. By one rule of thumb, a 5% rise in the euro's trade-weighted value has the same impact on growth and inflation as an increase of one percentage point in interest rates. This year's quarter-point cut has therefore been nowhere near enough to offset the euro's 6% gain since mid-December.

Moreover, the euro is likely to rise further. Not only have investors become less eager to finance America's huge current-account deficit, but with little room left to cut interest rates to boost their own

economy, American policymakers will be more than happy to let the dollar slide. Economists at HSBC are tipping the euro to reach $1.20 by the end of this year. Yet most economic forecasts, such as those of the OECD, assume no change in the exchange rate. If the euro rises strongly, growth will be weaker and inflation lower.

Japanese lessons

A second criticism of the ECB's policy is that, in current circumstances, it may not be sensible to focus, as the central bank does, on the average inflation rate in the euro area, if this risks creating deflation in Germany. The zone's headline inflation rate has stayed stubbornly above 2% in the past year, although core inflation (which excludes energy and food) is now 1.8%. However, Germany's core inflation rate is only 0.6%, perilously close to deflation.

Japan's experience has shown how dangerous deflation can be. Falling prices increase the real burden of debt, and real interest rates cannot be reduced to boost the economy, because interest rates cannot be negative. The lesson from Japan is that, if there is the slightest risk of deflation, monetary policy needs to be looser than warranted by current economic conditions. For once deflation has taken hold, monetary policy becomes a blunt tool. This is even more important when fiscal policy is also severely constrained by Europe's stability and growth pact.

Interest rates are already too high for Germany. Given the harm deflation can do, the ECB arguably needs to cut interest rates by more than seems appropriate for the euro area as a whole in order to prevent deflation in the zone's biggest economy. It may be too late. Even assuming more rate cuts soon, economists at Dresdner Kleinwort Wasserstein (DrKW) forecast that core German consumer prices will fall by 0.3% in the year to June 2004. Using the Taylor rule, and his own forecasts for inflation and output gaps, David Owen of DrKW calculates that Germany would need negative nominal interest rates (if that were possible) by early next year.

Indeed, the ECB may be underestimating the risk of a big fall in inflation across the euro area. If growth remains well below trend and the euro rises, the average core inflation rate will fall below 0.7% next year. That is a strong argument for cutting rates now. There is also a risk of deflation in France, where core inflation is expected to fall near to zero next year.

It is popular to blame Europe's sluggish growth on structural rigidities. On a long-term view, that is surely right: structural reforms are essential to improve economies' performance. But the benefits of reforms will take a long time to appear, and they will do nothing to prevent deflation. The euro area's immediate problem is overly tight monetary and fiscal policies.

Germany's low inflation rate, its limited room to ease monetary or fiscal policy and the problems in its banking system look horribly like the early symptoms seen in Japan in the mid-1990s before it sank into deflation. How appropriate, therefore, that Heizo Takenaka, Japan's economics minister, is calling for the ECB to ease policy more aggressively than it has hitherto. Hopefully, the ECB has better hearing than the Bank of Japan.

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Reverse snobbery

Signal failure?

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From The Economist print edition

The economics of understatement

ECONOMISTS have long been obsessed with signals. Slogging through an MBA course, for example, might not raise your productivity, but the mere fact that you bothered to do so—and paid thousands for the privilege—tells employers something about you. People of above average ability want to show that they are a cut above the riff-raff, and are willing to pay for it.

So far, so simple. But signalling theory copes badly with real-word nuances. How can economists explain the confused or even false signals people often send? Some university hopefuls like to dress like urban gangsters. The best companies sometimes prefer discretion to shouting about their merits, or even delay their results. Isn't this irrational, and further evidence of the uselessness of economic theory?

Not according to a recent article* in the *RAND Journal of Economics*, which argues that such behaviour is readily explicable. Rather than assume (as most signalling models do) that there are just two classes of people—above and below average—the authors start with three categories: high, medium and low ability. "Countersignalling"—pretending to be less bright than they really are—is then one way in which people of high ability can set themselves apart from the merely middling.

Suppose that a mixture of people apply for a job. Interviewers have two sources of information about their quality: exam grades and a personal recommendation. Because these are imperfect signals, middle-ability applicants might be confused with either high-ability or low-ability types. To distinguish themselves from the dross, they boast about their grades. The high-quality people, however, know that their grades and references will distinguish them from those of low ability. By not bothering to mention their grades, they set themselves apart from the middle group as well. The authors back up their theory with classroom experiments.

Countersignalling, say the authors, can explain why mediocre students are keen to answer a teacher's easy questions, while the best students are embarrassed even to bother raising their hands, and why minor, insecure managers are obsessed with displays of power. The trouble now is that those of middle rank are sure to grasp the idea. What will high-flyers do next to distinguish themselves? Expect soon the theory of counter-counter signalling.

* "Too cool for school? Signalling and countersignalling" by N. Feltovich, R. Harbaugh and T. To. RAND Journal of Economics, Winter 2002

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Economics focus

Gauging generosity

May 1st 2003
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Which rich countries do most to help poor countries?

JUDGED by their rhetoric, rich countries are falling over themselves to help the world's poorest. The current multilateral round of trade negotiations is called the Doha Development Round, because it is meant specifically to help poor countries. Jacques Chirac, host of this June's G7 summit, wants to focus the meeting on Africa. France's to-do list includes a moratorium on subsidies on exports to Africa, trade concessions and new efforts to stabilise commodity prices. George Bush, who in 2002 proposed a 50% increase in America's aid budget over three years, this year offered to triple spending to combat AIDS in Africa.

Promises aside, which rich countries actually have policies that help the poor? The traditional gauge of a country's commitment to development is foreign aid. Total aid flows rose in 2002, by 4.8% after inflation. America is the biggest donor in absolute terms, but the stingiest relative to the size of its economy, spending only 0.12% of its GDP. Denmark, Norway and the Netherlands were the most generous. Each gave more than 0.8% of their national income. However, aid is not the only, or even the best, measure of help. Trade policy is crucial: shutting out their exports is a sure way of condemning the poor to remain poor. Liberal immigration policies can also help, because migrant workers' remittances support their home economies.

A new index drawn up by the Centre for Global Development (CGD), a Washington think-tank, with *Foreign Policy* magazine, attempts to rank 21 rich countries by averaging their scores in six development-related policies: aid, trade, the environment, migration, investment and peacekeeping. The Netherlands, says the CGD, comes top (see table and, for more details, www.cgdev.org). Norway, although a generous aid donor, ranks only tenth, mainly because of its protectionist trade policies. America scores well on trade but badly on everything else, and so is ranked second-bottom, above only Japan.

Helping hands

Commitment to Development Index scores*

	Aid	Trade	Environ-ment	Invest-ment	Migration	Peace-keeping	Average
Netherlands	6.9	7.0	5.7	6.1	4.5	3.5	**5.6**
Denmark	9.0	6.8	5.0	1.0	4.4	7.1	**5.5**
Portugal	2.2	6.9	5.1	9.0	1.0	6.8	**5.2**
New Zealand	1.7	7.2	3.4	2.3	9.0	6.9	**5.1**
Switzerland	3.3	4.0	7.2	6.3	9.0	0.1	**5.0**
Germany	2.1	6.8	6.0	1.4	8.1	3.8	**4.7**
Spain	2.4	6.8	6.0	8.2	1.8	2.9	**4.7**
Sweden	7.0	6.9	6.1	1.8	3.9	1.3	**4.5**
Austria	2.8	6.8	5.4	2.6	6.5	2.6	**4.4**
Norway	6.6	1.0	2.8	3.5	4.6	7.4	**4.3**
Britain	3.0	6.9	5.0	3.4	3.1	3.6	**4.2**
Belgium	3.5	6.7	4.5	1.4	4.5	3.5	**4.0**
Greece	1.5	6.7	4.6	0.0	1.6	9.0	**3.9**
France	3.1	6.8	4.9	1.7	0.8	5.2	**3.8**
Ireland	2.6	6.6	1.6	2.3	4.5	3.7	**3.6**
Italy	1.4	7.0	5.3	1.5	1.1	5.3	**3.6**
Finland	3.0	6.8	5.4	1.7	1.3	2.9	**3.5**
Canada	1.7	6.6	1.7	2.1	6.1	2.4	**3.4**
Australia	1.7	7.2	1.8	1.6	3.7	2.8	**3.2**
United States	0.8	7.7	1.0	2.0	2.3	1.5	**2.6**
Japan	1.2	4.6	4.0	2.8	1.5	0.5	**2.4**

Source: Centre for Global Development

*Minimum 0, maximum 9

In both theory and construction, the best components of the index are aid and trade. The CGD study does not simply rank countries' ratios of foreign aid to GDP, but adjusts them to capture the quality as well as the quantity of aid. It deducts administrative costs. It strips out principal and interest repayments made by poor countries, because a lot of “aid” is in fact low-interest loans, not gifts. It discounts “tied aid”, which must be spent on goods and services from the donor country, by 20%. Aid to poorer countries that are well governed counts more than aid to richer developing countries (which need it less) or poorly run countries (which are more likely to waste it). Japan does badly, because most of its aid consists of loans. America scores worse. However, if America's vast philanthropic foundations, which give a lot of aid privately, were included, its aid score would rise, although its overall ranking would not.

The good, the bad and the arbitrary

America's trade policy, in contrast, is ranked top. The CGD measures trade policy mainly by combining information on tariffs, non-tariff barriers and domestic subsidies. To capture other forms of protectionism, such as discriminatory regulations, the index also looks at how much is in fact imported from poor countries. America scores highly because its economy, broadly, is the most open. Norway, Switzerland and Japan come last.

The ranking on migration policy is surprising. Switzerland—not normally thought of as open to foreigners—comes top, along with New Zealand. A country's score is based largely on the number of legal migrants from developing countries it accepts relative to its population.

The other three elements of the index have less to be said in their favour. The investment-policy component is based mostly on flows of direct investment from rich countries to the developing world. Unlike the aid element, therefore, it reflects corporate decisions rather than government policy. The main finding is the extent to which flows still reflect old colonial ties: firms from highly ranked Spain and Portugal, for example, are big investors in Latin America.

The environmental index tries to capture how much rich countries deplete global environmental resources, for example by measuring greenhouse-gas emission per head. It also looks at their contributions to clean technology and commitment to environmental treaties. Not surprisingly, the United States comes bottom. Yet this component seems arbitrary. Granted, rich countries' environmental policies affect poor countries, but so does investment in pharmaceutical or agricultural research.

America also ranks near the bottom in peacekeeping. That will astonish many Americans. The reason is that the index is based on contributions to multilateral peacekeeping efforts, relative to GDP. Greece, which comes out top, shines because it sent 2,000 peacekeepers to Bosnia and Kosovo. However one regards America's foreign policy, America's contribution to multilateral peacekeeping surely understates the country's contribution to global security. Besides the more spectacular episodes, the American navy renders many sea-lanes safe.

These caveats imply that the CGD index is far from the last word on development policies. As its authors acknowledge, it is a crude first stab at measuring the rich world's help for the poor. It is inevitably flawed, but it does make clear that aid alone is a misleading guide. Trade and peace matter at least as much.

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Malaria

Four horsemen of the Apocalypse?

May 1st 2003 | IWAYA
From The Economist print edition

Panos

Infectious diseases are in the news. Here are reports on four of them (second report, third, fourth). First malaria, which kills ten times as many people a day as SARS has killed in total

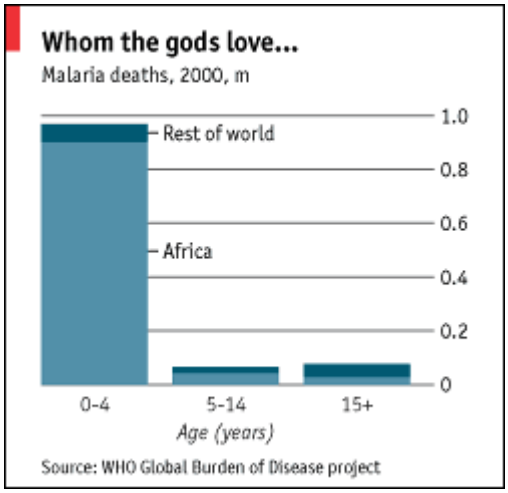
Get article background

THERE is no spare space in the slums, so the people of Iwaya build their homes on wooden stilts above a sewage-filled swamp. They punt around in pirogues, and earn their living, mostly, by netting fish for the hungry millions of Lagos, the Nigerian metropolis on whose edge this village floats. Despite the abundant purple blossoms on the water's surface, Iwaya is an unattractive place to live. Unless, that is, you are a mosquito.

Malaria is, unsurprisingly, the most troublesome disease in Iwaya. As Anwan Soulu, a local health worker, observes, the dirty water is a breeding ground for mosquitoes. On the plus side, in Nigeria, as in most of West Africa, drug-resistant strains of malaria are less common than in the eastern or southern parts of the continent. Iwaya's dispensary, a stuffy bamboo cubicle above the swamp, sells plenty of chloroquine, one of the oldest and cheapest anti-malarials, which is nearly useless in most of the rest of Africa.

Last week, two organs of the United Nations, the World Health Organisation and Unicef, issued a comprehensive report on African malaria, the first of its kind. The numbers are not completely reliable. Diagnosis in Africa rarely involves sensitive laboratory tests, and in much of the continent the disease is so common that anyone who arrives at a clinic with a fever is simply assumed to have malaria, and treated accordingly. Nevertheless, it looks as though at least 1m Africans die of malaria each year, more than 90% of them children under five (see chart). Among infectious diseases, therefore, malaria's impact is second only to that of AIDS. And besides slaying infants, malaria makes adults too feverish to work. In the worst affected parts of Africa, this happens so often that it is a serious obstacle to climbing out of poverty. By one estimate, malaria costs Africa $12 billion a year in lost output. And a study in Ghana found that poor families spent a

third of their cash income on malaria treatment. Furthermore, this colossal burden appears to be growing heavier.



Bad to worse

In eastern and southern Africa, malaria mortality among children under five was nearly twice as high in the 1990s as in the previous decade. In some African countries, it remained stable, but in none was there a significant improvement.

There are several likely reasons for this. One is the speed at which chloroquine-resistant parasites have evolved. This has not been matched by progress in the development or distribution of new drugs. Another is the spread of AIDS, which undermines the body's defences against malaria. Other reasons include the breakdown of malaria-control programmes (as Africa has grown poorer), and greater personal mobility. When people from non-endemic areas, who have little natural immunity, travel to endemic ones, they are especially vulnerable.

Malaria has not been so intractable elsewhere. In the 1950s and 1960s, insecticides such as DDT helped to control or eradicate malarial mosquitoes in much of Asia and Latin America. But Africa has proved harder to treat. In the area south of the Sahara, which is where most Africans live, mosquitoes are too plentiful and too tough to wipe out. They are also much more likely than non-African mosquitoes to carry the deadliest of the four malarial parasites, *Plasmodium falciparum*. Eventually, the world more or less gave up trying to conquer African malaria.

Since the late 1990s, however, battle has been rejoined. Donors have promised more money, and African governments have promised to make better use of existing weapons in the anti-malarial armoury, the cheapest and most effective of which have been woefully neglected. Bednets treated with insecticide, for example, have been shown to cut infection rates by half, but less than one vulnerable child in 20 sleeps beneath one. The main obstacle is price. Although nets have grown cheaper in recent years, they still cost about $5 each—as much as a typical African country spends on health care, per person, each year. Subsidies can help, as a startlingly successful net-distribution campaign in Eritrea has shown, as well as smaller experiments in Tanzania and Zambia. But at the very least, malaria-prone countries should not tax bednets, as 26 African states still do, despite having promised three years ago that they would stop.

Another proven tactic is to provide pregnant women with a couple of hefty doses of anti-malarial drugs when they visit antenatal clinics, whether they show symptoms of the disease or not. This is simpler than pill-a-day prophylaxis, and protects both the women and their babies. Six countries have made this “intermittent preventive treatment” their national policy. Several others are considering it.

In some parts of Africa, such as the highlands of eastern Africa, the Sahel and the deserts of southern Africa, malaria is not a constant threat, but comes in sudden epidemics. The damage can be reduced if such outbreaks are spotted early. By studying weather forecasts, the Southern African Malaria Control programme has been able to predict epidemics, with reasonable accuracy, up to six weeks in advance. It also collates data from clinics, to alert health authorities to outbreaks that have actually occurred. Between 1998 and 2000, this enabled the governments of Botswana, Swaziland and South Africa to detect all epidemics within two weeks, and to respond within two weeks of detection. Less well-run countries, such as Zimbabwe, did less well.

The final line of defence is drugs. More and better ones are needed. Where chloroquine fails, artemisinin-based combination therapy is usually effective, but these pills are expensive and unfamiliar, so donor help will be important in promoting their use.

Best of all would be a vaccine, which does not yet exist, at least in part because profit-driven drug firms have little incentive to invent one for a disease that affects mainly poor people. In the past couple of years, however, organisations such as the Bill and Melinda Gates Foundation have sponsored some encouraging research. The most promising candidate is currently in clinical trials in Mozambique, and might, conceivably, be ready by 2011. Africa may yet be a comfortable place for people, as well as mosquitoes.

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Anthrax

Publish and perish?

May 1st 2003
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The anthrax genome has just been published. Should it have been?

Get article background

THE rapid progress of genomics means that the publication of yet another gene sequence for one of the Earth's many millions of species is not guaranteed to raise much interest. But this is no ordinary species. *Bacillus anthracis* is the bug that causes anthrax. The publication, in *Nature*, comes two months after a group of editors of the world's leading scientific journals announced they were worried about publishing information that could be used by terrorists to evil ends. New procedures had therefore been put into place to tackle this threat. The question is, do they work?

The genetic sequence in question was decoded by scientists at the Institute for Genomic Research (TIGR), in Maryland. The bug involved was isolated in 1981 from a Texan cow. It turned out to contain more than 5,000 genes, and "annotation" of these genes has identified possible functions for about 65-70% of them—including a number that are responsible for the bacterium's virulence. Earlier work that did not require the complete sequence to be known had shown that this strain is virtually identical to that used in the letter-borne terrorist attacks that paralysed America's Congress late in 2001.

Bugs in the programme

Work on the anthrax genome has been under way for several years. Over a year ago, in the light of the postal attacks, there was some discussion of whether sequence data from pathogens that might be used as terrorist weapons should be published. At the time John Marburger, director of the White House Office of Science and Technology Policy, explained that publication of such sequences was not likely to help terrorists. However, he added that annotation was cause for greater worry. "The further you go into details of how organisms operate, the more concern there would be, but this is a subjective issue and it is difficult to say where the line should be drawn." Given that subjectivity, the best people to make these decisions, it would seem, are scientists themselves.

One such scientist, Claire Fraser, TIGR's boss, argues that more good than harm will come from having the sequences of pathogens in the public domain. She says the information will aid researchers who are trying to understand what makes a bug pathogenic. The large increase in biodefence funding in America has invigorated research on pathogens such as anthrax that might be turned into weapons by terrorists. Such research, she says, requires just this kind of information. So does work on new vaccines and antibiotics.

What about classifying research such as this, so that only scientists who had the appropriate security clearances could read it? Dr Fraser says that the problem with this approach is that, if TIGR had not sequenced, annotated and published the anthrax genome, a laboratory abroad would have done so instead. But this, perhaps, is where the power of the editors of the international journals comes in.

Don Kennedy, the editor-in-chief of *Science*, agrees with Dr Fraser. He says that publishing sequences of organisms that might be used for terrorism can pose a risk, but that the potential benefits may well outweigh the risks—depending on the specific contents of a particular research article. There is, however, that word "depending". Presumably, in the aftermath of the editors' conference, someone at *Nature* carefully weighed the pros and cons of publishing the annotated sequence of anthrax when it arrived at the journal.

Actually, no. Chris Gunter, the editor at *Nature* who was responsible for handling the anthrax paper, says

that no special consideration was given to the risks of publishing it. The reason was that its core information had already been published in an online public database called GenBank. All *Nature* did was to package the paper with some scientific analysis.

Of course, security could have been maintained by withholding the data from GenBank while the risks were assessed. However, as Dr Fraser points out, it is a condition of her funding from the American government that she deposits gene sequences in GenBank soon after they are discovered. So, in a nutshell, it appears that nobody apart from the scientists who sequenced the information has specifically evaluated the risks and benefits of publishing the anthrax sequence.

Some critics argue that the publication of this sequence typifies the sort of problem that the scientific community is creating for itself. But in this case the political authorities seem just as much to blame, if blame there be, as gung-ho researchers who cannot see the security wood for the scientific trees. In any case, the publication also underscores the difficulty of keeping scientific information secret. Once it is known how to do something, it is hard to stop undesirables doing it anyway—so why hamstring your own side with needless restrictions? Besides, the editors of scientific journals cannot act as gatekeepers for all of science. Scientific information is communicated by many means, through seminars, meetings and electronic posting on the web. Information, as Stewart Brand observed, wants to be free. In this case it is probably best to let it be so.

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Influenza

For the birds

May 1st 2003
From The Economist print edition

Beware of bird flu. Many human infections have animal precursors

WHILE Severe Acute Respiratory Syndrome (SARS) grips the world's attention, the Netherlands has its hands full with a different, and even more deadly, epidemic: avian influenza. Admittedly, as the name suggests, the victims of this disease are mainly birds—in particular, chickens. But human influenza epidemics usually start in pigs or poultry, and this strain has already infected 80 people, one of whom has died.

In much the same way that foot-and-mouth disease (FMD) took Britain by surprise in 2001, the Netherlands has been caught out by avian influenza. The country does not have a recent history of the disease, so it came as a shock to farmers and vets when the first cases were detected in late February in Gelderse Vallei, in the middle of the country. Avian influenza is highly infectious, spreading mainly through contact with bird droppings, and can be carried by dust, or on people's clothes. Experts think the outbreak may have started through chance contact between farmyard chickens and wild fowl, which are known reservoirs of the virus. The disease quickly spread to other parts of the country, and also to Belgium.

Gelderse Vallei used to be home to 10m poultry, one of the mainstays of the Dutch intensive chicken and egg industry. No longer: most of those animals have since died, some from the disease, but the majority from mandatory slaughter imposed by the government. Unfortunately, vaccination is not a viable option in the Netherlands, according to Andre Bianchi, head of the Central Institute of Animal Disease Control in Lelystad, since it is too expensive, and existing vaccines are not particularly good against the highly pathogenic form of the virus now doing the rounds.

The upshot, so far, is the slaughter of more than 18m poultry—or almost 20% of the country's entire flock—on more than 1,000 farms. This puts the Dutch outbreak ahead of the world's last big episode of avian influenza, in Hong Kong in 1997. Then, 1.4m chickens were destroyed, virtually the territory's entire stock. The Dutch government estimates the direct costs of controlling the disease and compensating farmers will come to *euro*220m ($240m). Looking back at other disease outbreaks in the country, among them FMD and swine fever, Ruud Huirne, an economist at Wageningen University, reckons that the total economic loss due to avian influenza could reach *euro*1 billion.

The human infections are disturbing, but not, as yet, cause for serious concern. The victims are mainly farmers and vets who have caught the virus from infected animals. There is no evidence that this strain of influenza can be passed directly from person to person, and most human victims have had fairly mild symptoms. Before SARS hit Hong Kong earlier this year, though, three people died from avian influenza caused by a different strain from the Dutch virus. All the more reason for the Dutch authorities to hope that their control measures work before their version comes home to roost for good.

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SARS

Good times, bad times

May 1st 2003
From The Economist print edition

Some health authorities are getting a grip on SARS. China's, however, are not

Get article background

ON APRIL 28th, Vietnam became, according to the World Health Organisation (WHO), the first country to contain Severe Acute Respiratory Syndrome (SARS). Cases of SARS seem to have peaked, too, in Toronto, Singapore and Hong Kong. Understanding of the disease may also have advanced a little, with observations suggesting that the tissue damage it causes may be a result not of the virus directly, but of the immune system's response to it.

The bad news, though, is that the case load is still rising in mainland China. On April 30th, 11 more people died and another 166 were infected, taking the total number of cases on the mainland to 3,460. In Beijing, 9,650 people are in quarantine. The city's hospitals are unable to cope. Speaking at a summit of Asian leaders in Bangkok, Wen Jiabao, China's prime minister, gave a warning that SARS was going to be a long-term, complex and relapsing epidemic—in effect, becoming endemic rather than merely epidemic. If the disease does, indeed, become endemic in China, the problem of containing it would be a permanent burden on the whole planet's health authorities.

More bad news is that the infection's death rate is probably much higher than first estimated. That estimate had already inched up from 4% to 6%. Now, a study of 1,400 cases in Hong Kong by Roy Anderson, an epidemiologist at Imperial College, London, reckons that between 8% and 15% of those contracting SARS will die. (This increase is not because the disease is becoming more dangerous. It is a statistical effect caused because earlier on in the epidemic many patients who were going to die eventually had not yet done so.)

It is also becoming clear that the death rate differs in different populations of patients. Virologists would dearly like to know why some people become sicker than others, and why the pattern of the disease varies (diarrhoea, for example, was more common in one particular outbreak than in others).

One intriguing possibility is raised by a paper published online in the *Lancet* on April 29th. This suggests that SARS may take a less aggressive course in younger children (those under the age of 13). The findings are tentative, being based on a small sample of cases in Hong Kong. As the WHO points out, a study of ten children is too small to draw meaningful conclusions. However, some unconfirmed reports suggest that of the hundreds of people killed by SARS so far, none has been a child.

Tai Fai Fok, a paediatrician at the Chinese University of Hong Kong and one of the authors of the study, told *New Scientist* that one of his hypotheses for why SARS causes a milder illness in young children is that their immune systems are still developing. The suggestion is that the virus does not actually kill human cells, but rather that the damage is done by an over-reacting immune system attacking the lining of the lungs—a so-called autoimmune response.

Intriguingly, this would fit in with reports in *Newsday* that AIDS patients in a Chinese hospital resisted infection despite their proximity to SARS patients. If SARS is the result of an autoimmune response, AIDS patients might, ironically, be at lower risk, because their immune systems have been damaged by a different virus—HIV.

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New fiction

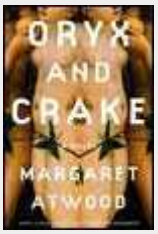
Biting at the future

May 1st 2003
From The Economist print edition

Contemporary novelists rarely write about science or technology. Margaret Atwood tackles both—and more—in one of the year's most surprising novels

MARGARET ATWOOD takes care to construct her futuristic nightmares out of current materials. Nearly two decades ago, in “The Handmaid's Tale”, the 63-year-old Ottawa-born poet and novelist posited an unholy alliance between puritan feminism and Bible-belt fundamentalism, from which she brewed a horrible and bizarre form of social engineering. “Oryx and Crake” is that book's companion piece—there are many detailed echoes—but the ingredients are genetic engineering, climatic catastrophe and global pandemic. The scary thing is that this latest book seems less contrived, less invented than the first. Ever heard that the protein in spider's silk can be harvested from goat's milk to make bulletproof vests? Ms Atwood didn't make it up.

Oryx and Crake
By Margaret Atwood



Doubleday; 378 pages; $26.
Bloomsbury; £16.99

Buy it at
Amazon.com
Amazon.co.uk

The narrator in “Oryx and Crake” is Jimmy, hungry and up a tree, to avoid the wolvogs—genetically spliced creatures, as waggy as dogs and vicious as wolves. The landscape is hot and littered with detritus from the city that now stands some way out to sea: “Things happened, I had no idea, it was out of my control...listen to me please!” Once there were the “pleeblands” where “neurotypicals” lived. “Genius gene” people lived in fortified genetic-science compounds named HelthWyzer, RejoovenEsence or AnooYoo, all developing immortality products.

Jimmy, though compound-born and bred, scored high on words, but low on numbers. Only the scruffy Martha Graham Academy, a once-rich performing-arts college, would have him. Now it offered courses in things like “Webgame Dynamics”; in sophomore “VizArts”, Jimmy had done “The Maltese Falcon” with costumes by Kate Greenaway and “depth-and-shadow styling by Rembrandt”.

Meanwhile, Jimmy's “genius gene” schoolfriend, Crake, has been snapped up by the Watson-Crick Institute (like Harvard “back before it got drowned”), where students are given half royalties in anything they invent. Chickens, for example, that produce only drumsticks—“twelve to a growth unit”; or

“Rockulators”, plastic and plant “combo-matrix” rocks for lawn regulation, absorbing and releasing water according to the ambient humidity. For drinking water there's the Moses model: “Just Hit It With A Rod”.

Crake's beautiful, enigmatic girlfriend, Oryx, was first glimpsed by the two friends when they were teenagers, surfing the porno sites. When she turns up they both fall in love with her, but for all the grittiness of her story she retains a virtual quality, like a piece of graphics. But then what is real here? Crake's secret “Paradice Project” is the creation of a perfect race: peaceable, vegetarian and cellulite-free. Reality intervenes when he slips a “hostile bioform” into the pleeblands—to keep the pharmaceutical companies happy. “For maximum profit”, says Crake, “the patient should either get well or die just before his or her money runs out. It's a fine calculation.” Accidentally, the bioform wipes everyone out, except for Jimmy, Crake's humanoid tribe, and the animals.

All of this is done on a roll of dry, black, parodic laughter. Ms Atwood loves lingo, the shrunken language of advertising, brand names, slogans, corporate-speak, webtalk—above all the heartless language of scientific reductionism. Jimmy himself is a closet romantic, hoarding old expressive words, but he has to fight hard against all this knowingness. Post-catastrophe, he finds it hard to remember any language.

One of Ms Atwood's themes in “Oryx and Crake”, as in “The Handmaid's Tale”, is the fragility of memory, and therefore of civilisation. Break the generational link, and soon no one will remember how it was. But this time she has a twist. Crake's Paradice people are blanks, outside history. If Crake had had his way, they would never have developed one. Every destructive impulse has been screened out: competitiveness, territoriality, hierarchy—even sex, beyond seasonal reproductive periods. They are the beautiful and the bland. And yet, when Jimmy makes a scavenging journey to Crake's old compound, they worry. They make an effigy of him to magic him back. And Jimmy remembers Crake's words: “Watch out for art. As soon as they start doing art we're in trouble.” Art breeds idols, funerals, the afterlife, sin, kings, slavery, and war. So it comes round. Even from a standing start, the wheel will grind itself into motion again.

Oryx and Crake.
By Margaret Atwood.
Doubleday; 378 pages; $26.
Bloomsbury; £16.99

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About sponsorship

Political Islam

The Utopian tendency

May 1st 2003
From The Economist print edition

Paul Berman and Bernard Lewis (see article) assess militant Islam

Get article background

TWO important messages about extremism stand out from this essay about the roots of Muslim fundamentalism. Deep down, Paul Berman tells us, the spirit of violent Islamism is no different from the impulse towards totalitarian Utopias that blighted the West in the 20th century. This is a plausible and appealing view, which makes current threats intelligible to us in light of our own melancholy history. His secondary point is that you neglect intellectuals at your peril, however crazy they sound. Someday, somewhere people may try to kill each other—or you—in the name of their ideas.

Terror and Liberalism
By Paul Berman

Norton; 214 pages; $21 and £14.95

Buy it at
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Amazon.co.uk

Mr Berman, a contributor to the *New Republic* and the *New Yorker*, writes as an American liberal with fundamentalist foes of his own to contend with on the far left and the hard right. Looked at his way, extreme Islamism is neither a reaction to American imperialism, as left-wing thinkers like Noam Chomsky argue. Nor is it the result of an inevitable clash between civilisations or religious faiths, as certain popularisers of Samuel Huntington would have us believe. Instead, Mr Berman sees it as a pathological response to the encroachments of modernity, and in particular to the spread of liberal, democratic values. Plunging us back into the world of Islamic ultras in the 1930s and 1940s, he shows how closely their ideas resembled those of nihilists, fascists and communists.

In compelling detail, Mr Berman examines the writings of Sayyid Qutb (1906-66), an Egyptian religious scholar affronted by the secularisation of the Turkish state, who provided radical Islamists with their own ideology. Returning from study in Colorado, where American life both dazzled and appalled him, Qutb fell out with President Nasser. After a controversial trial for terrorism he was hanged. Qutb's brother, Muhammad, fled to Saudi Arabia, where he taught at King Abdul Aziz University. Among those who attended his Islamist lectures was Osama bin Laden.

The red thread in Qutb's voluminous writings was the need to restore harmony between human reason and the word of God. The trouble, in his eyes, lay not so much with the values that European rationalists, from Socrates to 20th-century liberals, had espoused. Rather it was the failure of modern society to live up to its ideals. Much like contemporary communists and fascists, Qutb gazed on the “landscape of liberal civilisation”—with its claims to democratic freedom, social justice and scientific rationality—and saw “a gigantic lie”.

Qutb's millennial cure was to sweep away the existing order and replace it with God's rule on earth. Qutb himself was a gentle, widely read man. He wavered, as revolutionary thinkers commonly do, between imagining the upheaval he was urging on the Islamic world as coming from above with the state-sanctioned imposition of Koranic law, or rising from below as moral regeneration by the faithful. His prose, Mr Berman tells us, was often more sensual than angry. Yet once you accept Qutb's divisive, us-and-them vision, it is but a step towards violence and civil war.

Mr Berman does not claim for his own the idea of extreme Islamism as a totalitarian menace. He acknowledges his debts to Albert Camus and to experts such as Gilles Kepel and Malise Ruthven. This is not a profound or rounded study, but a fluent and lucid essay by one of America's best exponents of recent intellectual history.

Terror and Liberalism.
By Paul Berman.
Norton; 214 pages; $21 and £14.95

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About sponsorship

Islam and the West

How many bin Ladens?

May 1st 2003
From The Economist print edition

Get article background

The Crisis of Islam: Holy War and Unholy Terror
By Bernard Lewis

Modern Library; 184 pages; $19.95. Weidenfeld & Nicolson; £12.99

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Amazon.com
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FROM his perch at Princeton, Bernard Lewis has become one of Islam's foremost interpreters in America, a role that has taken on immense importance since the felling of the twin towers. This short book, based largely on articles Mr Lewis had already published in the *New Yorker*, *Foreign Affairs* and *Atlantic Monthly*, is lucid and stylish. But it is limited—perhaps misleadingly limited—in scope.

For those who have not been paying attention since September 11th 2001, Mr Lewis reprises some of the sharp differences between Islam and the West. In the West, says Mr Lewis, the basic unit of organisation is the nation, subdivided in various ways, one of which is by religion. Muslims tend to think in terms of a religion subdivided into nations. Christians have learnt to render unto Caesar the things that are Caesar's. Few Muslims, cleaving to god-given sharia law, accept this separation between the spiritual and temporal. Moreover, Christianity has no counterpart to the *jihad*, the holy war which under Muslim tradition should continue until the whole world adopts the Muslim faith or submits to Muslim rule. The crusades were merely "a long-delayed, very limited, and finally ineffectual response" to Islam's conquests.

AP

Bad luck, America

This is all fine so far as it goes. And Mr Lewis offers some fresher insights along the way. He argues, for example, that the crusades aroused remarkably little interest in the Islamic world at the time they occurred. But interest grew rapidly in the 19th century, when Muslims began to reinterpret them as an early prototype of the encroachments of European imperialism. In the minds of Islamic radicals such as Osama bin Laden, all such episodes are slotted neatly into a pattern of perennial conflict between the world of the believers and that of the unbelievers. It was, Mr Lewis surmises, the defeat in 1918 of the Ottoman sultanate to which Mr bin Laden was referring in the famous post-September 11th videotape lamenting Islam's 80-year-old "humiliation and disgrace".

The limitation of the book is that it does little to help the reader to form even a rough view about how many Muslims are sympathetic to this bleak bin Ladenesque interpretation of Islam. Mr Lewis allows that for many and "perhaps most" Muslims, Mr bin Laden's 1998 *fatwa* "against the Jews and the crusaders" is a travesty of Islam's nature. Many observers of Islam will bridle at the inclusion of that "perhaps". In

fairness, Mr Lewis does say at the outset that terrorism of the al-Qaeda sort does not require large numbers, and that it makes sense to explain the forces that drive the terrorists. So it does. But it surely behoves a voice as influential as his to make some assessment of how representative the terrorists' views are.

Without this, there is a grave danger of exaggerating the civilisational conflict between Islam and the West. Mr Lewis wonders why al-Qaeda calls its enemies “crusaders”, given that the crusaders were European Christians, not the Americans or Jews against whom it has issued a formal declaration of war. His conclusion is that radical Islam has picked upon America more or less by default, simply because it is now perceived of as the leader of the unbelievers. In this view, George Bush is the successor of a long line of rulers, from the Byzantine emperors, to the Holy Roman emperors to Queen Victoria, who have obstructed the divinely ordained and inevitable spread of Islam. If al-Qaeda and its kind persuade most Muslims to think this way, says Mr Lewis, “then a dark future awaits the world”. Quite so. But this book tells you virtually nothing about how likely it is that many Muslims will buy the message.

The Crisis of Islam: Holy War and Unholy Terror.
By Bernard Lewis.
Modern Library; 184 pages; $19.95. Weidenfeld & Nicolson; £12.99

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Capitalism's success

Market methodology

May 1st 2003
From The Economist print edition

AFTER the Berlin wall fell in 1989, western liberal economies at last triumphed over communism's bumbling state control. Yet the wild hopes of people in the former Soviet bloc for quick capitalist success were destined for disappointment. Now, with the rise of the anti-globalisation movement, setbacks to economic reform in Latin America and a growing backlash against privatisation in rich countries, the headlines seem to point to some fading of the capitalist dream.

Well, not so fast. John Kay, one of Britain's leading economists, aims in his latest book to return some balance to the debate over the role of markets. He is at his best in his review of the big economic themes of the past century: why state planning failed; how international trade benefits both rich and poor; how stockmarkets blew up into such a bubble.

Mr Kay's urge to understand the unique evolution of markets in far-off places is most refreshing. He tours the flower market in San Remo for a locally grown version of perfect competition. He uses an auction of a painting by Van Gogh to illustrate how liberal economies allocate value to scarce goods. His analysis of electricity deregulation in Britain and the botched privatisations in Russia in the 1990s lead him to the same conclusion: that markets cannot be imposed, but are instead the sum of evolution and adaptation. They thrive within a society's laws and cultural norms; without them they fail.

His *bête noire* is the University of Chicago's economics faculty. Yet in his haste to attack the madness of seeming to offer an economic explanation for everything—even why people marry—he aims his fire not at the very real troubles of recent American capitalism but at a straw man he calls, grandly, the “American Business Model”. Similarly, Mr Kay expends too much energy knocking down another false target: the idea, attributed to free-marketeers, that people are utterly greedy in all parts of their lives. Evidence against mankind's extreme selfishness is so easy to find—look at tipping, child-rearing or charity—that even Chicago's economists have noticed it. Yet Mr Kay sheds no light on whether more competition should be encouraged in the distribution of health care, say, or water supplies, or whether raising or lowering taxes improves economic growth. And what does he have to say when market competition collides with social solidarity? That “these are not always easy to reconcile”. No indeed.

Mr Kay plumps not for raw capitalism but for “disciplined economic pluralism”—which, of course, is rather close to what one can find in the many versions of capitalism that already exist throughout the world. As a literate account of contemporary debates over economics, Mr Kay's book is welcome. But readers who are seeking answers to the perennially difficult questions about the proper role of the state in economic affairs will have to look elsewhere.

The Truth About Markets: Their Genius, Their Limits, Their Follies.
By John Kay.
Penguin/Allen Lane; 479 pages; £25

The Truth About Markets: Their Genius, Their Limits, Their Follies
By John Kay

Penguin/Allen Lane; 479 pages; £25

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About sponsorship

Australian politics

Keeping them out

May 1st 2003
From The Economist print edition

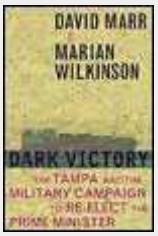
Get article background

ITS government likes to claim that Australia is the second most generous country, after Canada, when it comes to taking in refugees. But these are immigrants who have been screened and carefully selected—not those so desperate to escape torture and misery that they scrape together every cent they can for a ride in a cramped lorry or a leaky boat, a journey that often ends in death.

The numbers of smuggled refugees reaching Australia have been trivial compared with those who enter Britain and Germany. “But that was never the point,” David Marr and Marian Wilkinson conclude in their thorough and fast-paced account of Australia's war on immigrants. “Australians wanted no boat people at all.”

In August 2001, the government took extraordinary measures to keep 433 Afghan men, women and children fleeing the Taliban from reaching Australia. As their smuggler's boat was about to sink, the Norwegian captain of a commercial ship, the *Tampa*, obeyed international treaty obligations by going to their rescue. The Australian government tried to stop him. Refusing to back down, he took the shipwrecked refugees aboard ship. John Howard, leader of the conservative Liberal Party, made it a priority to keep the *Tampa* out of Australian waters.

Dark Victory: The Tampa and the Military Campaign to Re-elect the Prime Minister
By David Marr and Marian Wilkinson



Allen & Unwin; 360 pages; $19.95

Buy it at
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In turning on the boat people, the authors claim the Howard government engaged in covert operations, illegally monitored telephone conversations between the *Tampa* and lawyers for the refugees and tried to keep the details of the story from becoming public by muzzling military officers who knew what was going on.

AFP

Like this? Or tougher?

More was to follow. In the run-up to the 2001 election four months later, Mr Howard and the Liberal Party played the refugee card. “We Decide Who Comes to This Country,” a party poster said. It worked. Although Labor's policy toward refugees was hardly more benign, Mr Howard and the Liberals won easily. No refugee boats have entered Australian waters for more than a year. Mr Howard's supporters would say his get-tough policy has worked; the authors of this book call it, instead: “Dark Victory”.

Dark Victory: The Tampa and the Military Campaign to Re-elect the Prime Minister.
By David Marr and Marian Wilkinson.
Allen & Unwin; 360 pages; $19.95

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A history of laundries

Steamy

May 1st 2003
From The Economist print edition

KEEPING clean was a novel idea two centuries ago. The demand for laundry grew out of the discovery, in the 19th century, of links between dirt and disease, and from the emergence of clean clothes as a sign of social superiority.

Accessible water and hedges on which to hang things out to dry made the whole business of washing clothes much easier in rural villages. In cities, home launderers had to contend with a shortage of water as well as an abundance of smuts that settled on drying clothes. That led to the rise of the steam laundry, a business that in both Britain and America gave employment to thousands of women.

Thanks to William Strutt, who appears to have invented the first mechanical laundry (and so surely deserves a statue in his honour), these businesses hoped to emulate the efficiency of the factories that were beginning to mass-produce consumer goods. But they largely failed to reap economies of scale. Individual clothes need different treatments; and locating one lost collar in a thousand is harder than locating one in a hundred.

Laundry has always been a business that the poor can do from home. That held down wages. In time, the washers began to demand a decent wage and trade unions helped them organise to get it. But what killed the commercial laundry was the coming of the domestic washing machine, and reliable water and electricity supplies to run it. Even though the laundry owners warned women that they would be scalped in their wringers if they tried to do their laundry at home, the lure of the machine was too great.

It is true that the pictures of ancient washing machines and toiling launderers have a certain delicious nostalgia. However, this book—an expanded version of an academic study published four years ago by Arwen Mohun, a history professor at the University of Delaware—would have benefited from a chart or two, to compare the costs of home and commercial washing and changing pay rates. And it should have mentioned both the cataclysmic impact of the nylon shirt on the business and the survival of the dry-cleaner. Both, in their way, shaped society—as surely as the steam laundry did in an earlier century.

Steam Laundries: Gender, Technology, and Work in the United States and Great Britain, 1880-1940.
By Arwen P. Mohun.
Johns Hopkins University Press; 352 pages; $19.95 and £15

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About sponsorship

Looted Iraqi antiquities

Heavy history, light fingers

May 1st 2003
From The Economist print edition

Selling looted antiquities should not be easy. At least, that is the theory

FRUSTRATED archaeologists and museum curators are collaborating on legal moves and a name-and-shame campaign to try to publicise many of the antiquities that were stolen from the Iraq National Museum during the fighting in Baghdad last month, and make them more difficult to sell both at home and abroad.

Daily radio broadcasts in Iraq, together with entreaties to local neighbourhood imams, have resulted in the return of a number of small pieces to the museum. But the looters that the authorities would most like to see apprehended are those who entered the museum in teams, armed with glass-cutters, duplicate keys and the expertise required to distinguish between fakes and the real thing.

What to do with looters

Some of the museum's rarest works were targeted: a tall Sumerian masterpiece known as the Warka Vase, and the ivory Lion of Nimrud (pictured above). One stolen sculpture weighed 160kg and would have taken five men to carry away, leading many people to believe that the works were stolen to order. “This is a crime, not just against the Iraqi people”, Donny George, the museum's director of research, said on April 29th, “but against mankind.”

Distressed at the lack of protection afforded Iraq's museums by British and American troops, despite clear warnings that looting was likely, Iraqi curators are now collaborating with the British Museum and UNESCO to strengthen the legal framework that regulates the antiquities trade. A special motion was submitted to the UN Security Council on April 30th to retain sanctions on cultural artefacts coming from Iraq. Earlier, Tessa Jowell, the British culture minister, confirmed that the British government would “endeavour to strangle the market for tainted Iraqi property” by pushing through legislation that would make trading in illicit antiquities a criminal offence. Meanwhile, Mounir Bouchenaki, an assistant director-general of UNESCO, wants to establish a heritage police force for Iraq and has asked Interpol to police Iraq's borders for stolen antiquities.

Objects looted from the Iraq National Museum

The Warka Vase, a Sumerian masterpiece made in Gilgamesh's city, Uruk, and decorated with reliefs, from 3100BC

Gold decoration stripped from the reconstructed Lyre of Ur, found in the ruins of the city where Abraham was born

The Lion of Nimrud, the iconic victory of a lion attacking a Nubian, carved around 850-750BC

A headless inscribed statue of King Entemena of Lagash, the largest example of the lost wax method of casting, from 2400BC

Two figures from the reign of the Assyrian king Shalmaneser III. One returned in three pieces, one still missing

A copper statue base from Basekti, in the form of the lower part of a seated figure, with an inscription of King Naram-Sin of Akkad, from 2250BC

Ivory reliefs and a highly complex chair-back with a sun-disc symbol, from Nimrud, carved around 850-750BC

Marble statues of Poseidon, Apollo and Eros from the Roman-period Parthian city of Hatra, from 160AD

A head from the marble statue of a seated goddess, a bronze head from a Greek figure of Nike, and three limestone heads, all from Hatra

A marble casket from Hatra

A Roman statue from the time of Trajan

A limestone statue of Hermes from Nineveh, from 200BC

Rare, richly decorated wooden mosque doors from Mosul, 12th century AD

Source: Iraq National Museum, Baghdad

But keeping a vigilant watch over the market and reporting the sale of items suspected to have been looted may, in the long run, prove far more important. The museum in Baghdad is still without electricity, which has made it difficult to assess exactly what has been taken, especially from the store rooms in the basement. Meanwhile, a photographic database of the pieces already known to be missing is being established with the help of UNESCO and the British Museum. Archaeologists like piecing together shattered worlds. They will need more than their usual patience to rebuild Iraq's magnificent ancient collections.

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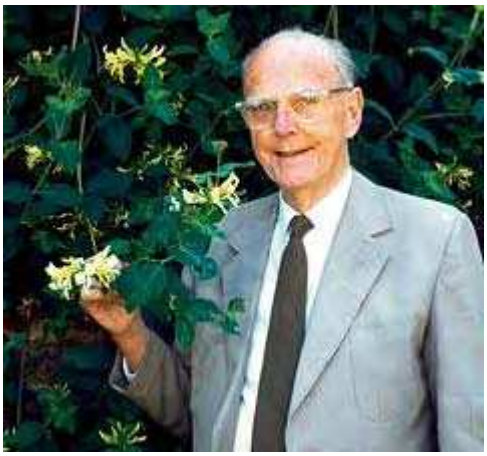
Graham Thomas

May 1st 2003
From The Economist print edition

Graham Stuart Thomas, gardener, died on April 17th, aged 94

National Trust



IT MAY be some comfort to those who like gardens but find gardening a hard grind, that Graham Thomas was of the same view. Mr Thomas was irritated by programmes on television that instantly turned a wasteland into an Eden. “Good gardening is never easy,” he said. Some people regarded Mr Thomas as the world's greatest gardener. He was certainly one of the most experienced. He reckoned that he first took an interest in gardening when he was six. His godfather gave him a fuchsia for his birthday, which, he said, “set me on my earthly career”. It continued for more than 80 years.

Much of his career was spent as adviser to the National Trust, which has the richest collection of gardens in Britain, and probably in the world. The trust was founded in the late 19th century to rescue the great aristocratic estates from what Mr Thomas called their “uncontrolled destruction” as a result of the growth of population, the spread of industry and the lack of planning. In the early days of the trust, gardens were looked upon as mere extras to the grand houses. Gradually they became valued for themselves, and in many cases regarded as more interesting to visitors than the houses they were attached to. Mr Thomas took charge of the gardens when many had fallen into scruffy ways and restored them to their former glory. He started with four and gradually took over all the main ones. He was the commanding officer of the pastures, woods and lakes in the trust's keeping. The militaristic title is apt. Mr Thomas saw his task as “a battle against nature”. He wrote,

> It is pleasant for a visitor to enter a garden and to find it in a good state of upkeep. But few...have any inkling of the ceaseless battle which goes on...against nature, a formidable adversary with arms of incal-culable diversity and resource, on the one hand, and against the wear and tear of people on the other...On a glorious June day it is easy to be persuaded that we are holding the fort, even winning. At other times we feel unnerved by the never-ending combat.

Tea with Miss Jekyll

Graham Thomas was in a gardening tradition that stretches back to Theophrastus, the most influential botanist of antiquity. Rather more recently, Gertrude Jekyll was regarded as the most influential of gardeners. In the autumn of 1931, when Miss Jekyll was 88 and almost at the end of her life, she had a letter about gardening from Mr Thomas, then 22, and invited him to visit her. She said she was too old to walk around her garden with him, but he should pick a leaf of any plant that interested him and they could discuss it over a cup of tea. The story is told in “The Garden Through the Year”, published in 2002, and the most recent of Mr Thomas's 19 books. He was too modest to suggest that this was the moment when a great tradition passed to the next generation. But it is a pleasing assumption.

His parents were keen gardeners and amateur musicians. The two interests often go together. Mr Thomas had a pleasant tenor voice and for many years sang with an amateur group. His early gardens were rather more sophisticated than those of most children. He recalled importing a seedling of a dwarf pine from Japan. It compared well, he noted, with a specimen in the botanic garden of Cambridge University. Cambridge was his home town and in his late teens he was taken on as a student in the 40-acre university garden, where Charles Darwin had once studied. After four years there he worked for a number of private nurseries, and started to build up a reputation as a writer on garden design and restoration. He reintroduced to English gardens many plants that had gone out of fashion, particularly

roses.

He gained all the medals and other honours that horticulture can grant. In plant catalogues his name frequently comes up. There is a “Graham Thomas” honeysuckle here, a rhododendron there. The most popular English rose is named after him, a winner in cool climates.

The millions of people who hopefully potter about in their gardens may be intimidated by Mr Thomas's scholarly approach. The man who restored the ruined gardens of Moseley Old Hall in Staffordshire (soil neutral, altitude 250ft, annual rainfall 27in) to their original state in the 17th century, when Charles II knew the place, did not seem the sort of expert you would ask about growing potatoes. Mr Thomas himself said that gardening was a “never-finished art” allied to craft. Yet he never forgot his earthy beginnings, digging and weeding. A lot of advice applicable to the humblest plot turns up in his 19 books. Avoid gimmicks such as painted fences, he said. They distract from the plants; stick to a well-placed urn. Anyone moving to a new house and garden should allow a growing season to pass, seeing what comes up before planting anything new. He was against plants that bloomed in vivid colours early in the season. Leave colour for later in the year. Design your garden yourself, and make it your own.

And although gardening involved physical work, it should be done thoroughly. In his last years Mr Thomas could no longer bend to dig in his own garden. He said he employed a man to dig and weed. “He does what I tell him,” said the master, a bit gruffly, “but that's about all I can say for him.”

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Overview

May 1st 2003
From The Economist print edition

America's economy grew sluggishly in the first quarter, as firms and consumers tightened their belts in anticipation of the war. GDP grew at an annualised rate of 1.6%, after annualised growth of 1.4% in the fourth quarter. In March, however, consumer spending outperformed dismal forecasts, and grew by 0.4%.

In April, **consumer confidence** soared in **Britain** and **America**, while business confidence soured in **France**. According to the Conference Board, American consumer confidence shot up from 61.4 in March to 81.0 in April, vastly exceeding analysts' expectations of a rise to around 70. In Britain, consumer confidence revived in April from an eight-year low. Business confidence in **France**, as measured by the INSEE survey, hit its lowest point in over a year, thanks in part to worries of threatened boycotts of French goods by American consumers.

Other figures for the **euro area** provided reason for even deeper pessimism. The European Commission's euro-area business climate indicator fell to its lowest level in 14 months. **France's** GDP shrank by 0.1% in the fourth quarter, a downward revision from an earlier estimate of 0.2% growth, and unemployment rose to 9.3% in March from 9.2% in February. French producer prices rose by an unexpectedly rapid 0.4% in March, to give a 12-month growth rate of 2.5%. **Germany's** Ifo index fell for the second month in a row in April, a sign of the renewed gloom in Europe's biggest economy. In **Italy** in the year to March, producer prices rose by 2.8%, and consumer prices by 2.7%.

Euro-area broad-money (M3) supply continued its record high annual growth of 7.9% in March, thanks partly to investors' preference for holding cash in uncertain economic times. Loans to the private sector fell more sharply than expected.

Despite the threat of war, **British** consumers spent avidly in March, lured to the shops by excellent weather. Retail sales rose by 0.6% during the month. In the first quarter, GDP growth was weaker than expected, at an annualised 0.7%, for a growth rate of 2.3% in the year to March.

The **euro** rose to $1.11, its highest level against the **dollar** in four years.

Canadian industrial production grew by 1.9% in the year to February.

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Output, demand and jobs

May 1st 2003
From The Economist print edition

% change on year ago

	GDP latest		GDP qtr*	The Economist poll GDP forecasts 2003	2004	Industrial production latest		Retail sales (volume) latest		Unemployment % rate latest		year ago
Australia	+ 3.0	Q4	+ 1.6	+ 3.0	+ 3.6	+ 2.3	Q4	+ 5.4	Q4	6.2	Mar	6.4
Austria	+ 1.3	Q4	– 0.5	+ 1.0	+ 1.9	– 1.5	Dec	+ 0.9	Dec	4.3	Mar	4.0
Belgium	+ 1.7	Q4	+ 1.2	+ 1.2	+ 2.2	– 1.6	Feb	– 5.3	Feb	11.7	Mar†	10.8
Britain	+ 2.3	Q1	+ 0.7	+ 1.9	+ 2.5	+ 0.1	Feb	+ 4.3	Mar	5.1	Feb††	5.1
Canada	+ 3.9	Q4	+ 1.6	+ 2.8	+ 3.3	+ 1.9	Feb	– 0.2	Jan	7.3	Mar	7.7
Denmark	+ 0.9	Q4	– 0.1	+ 1.5	+ 2.3	+ 3.3	Feb	+ 5.8	Feb	5.7	Feb	5.0
France	+ 1.5	Q4	– 0.3	+ 1.2	+ 2.3	+ 2.0	Feb	– 0.8	Feb	9.3	Mar	8.9
Germany	+ 0.5	Q4	– 0.1	+ 0.4	+ 1.6	+ 0.2	Feb	+ 0.7	Feb	10.6	Mar§	9.6
Italy	+ 1.0	Q4	+ 1.7	+ 1.0	+ 2.0	– 1.2	Feb	+ 0.8	Feb‡	9.0	Jan	9.0
Japan	+ 2.8	Q4	+ 2.2	+ 0.7	+ 0.8	+ 3.8	Mar	– 0.2	Feb	5.4	Mar	5.3
Netherlands	+ 0.4	Q4	– 0.4	+ 0.6	+ 1.9	– 1.6	Feb	– 2.5	Dec	4.9	Mar**	3.7
Spain	+ 2.1	Q4	+ 1.4	+ 2.1	+ 2.7	+ 2.5	Dec	+ 2.3	Feb	11.9	Feb	11.1
Sweden	+ 1.3	Q4	+ 1.2	+ 1.7	+ 2.4	– 1.8	Feb	+ 4.2	Feb	4.6	Mar†	3.8
Switzerland	+ 0.8	Q4	+ 1.4	+ 0.8	+ 1.8	– 2.1	Q4	– 1.3	Jan	3.9	Mar†	2.6
United States	+ 2.1	Q1	+ 1.6	+ 2.2	+ 3.3	+ 0.4	Mar	+ 4.6	Mar	5.8	Mar	5.7
Euro area	+ 1.3	Q4	+ 0.7	+ 1.0	+ 2.1	+ 1.8	Feb	+ 0.7	Feb	8.7	Feb	8.1
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*											
Finland	+ 2.8	Q4	+ 2.8	na	na	– 2.0	Mar	+ 5.1	Jan	9.9	Mar†	9.5
Greece	+ 3.5	Q4	na	na	na	+ 0.7	Feb	na		na		na
Iceland	– 3.0	Q4	na	na	na	– 0.3	2002	na		4.0	Mar†	2.7
Ireland	+ 6.9	Q3	na	na	na	+14.3	Feb	– 2.0	Feb	4.5	Mar†	4.4
Luxembourg	+ 1.0	2001	na	na	na	+ 3.1	Jan	+ 9.7	Dec	3.8	Feb†	2.9
New Zealand	+ 4.2	Q4	+ 2.0	na	na	+ 5.9	Q4	+ 7.3	Q4	4.9	Q4	5.4
Norway	– 0.1	Q4	+ 0.9	na	na	– 6.0	Feb	+ 0.9	Mar	4.4	Q1	4.1
Portugal	– 1.3	Q4	– 3.1	na	na	+ 3.4	Feb	+ 2.3	Feb	6.2	Q4†	4.2

*% change at an annual rate. †Not seasonally adjusted. ‡New series. ††Dec-Feb; claimant count rate 3.1% in Mar. §EU harmonised rate 8.9% in March. **Jan-Mar, new series.

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Prices and wages

May 1st 2003
From The Economist print edition

% change on year ago

	Consumer prices			The Economist poll consumer prices forecast		Producer prices			Wages/earnings		
	latest		year ago	2003	2004	latest		year ago	latest		year ago
Australia	+ 3.4	Q1	+ 2.9	+ 2.7	+ 2.5	+ 3.0	Q1	+ 0.5	+ 3.9	Q4	+ 4.9
Austria	+ 1.8	Mar	+ 1.9	+ 1.7	+ 1.3	+ 2.0	Mar	– 0.3	+ 2.2	Mar	+ 2.4
Belgium	+ 1.5	Apr	+ 1.8	+ 1.5	+ 1.4	+ 0.8	Mar	– 0.9	+ 2.4	Q1	+ 3.1
Britain	+ 3.1	Mar	+ 1.3	+ 2.8	+ 2.5	+ 1.9	Mar	– 0.1	+ 3.0	Feb	+ 2.6
Canada	+ 4.3	Mar	+ 1.8	+ 3.0	+ 2.2	+ 1.3	Mar	– 1.0	+ 2.1	Feb	+ 3.5
Denmark	+ 2.9	Mar	+ 2.6	+ 2.3	+ 2.0	+ 0.7	Mar	+ 0.8	+ 3.9	Q4	+ 4.1
France	+ 2.6	Mar	+ 2.1	+ 1.7	+ 1.4	+ 2.5	Mar	– 0.8	+ 3.5	Q4	+ 3.9
Germany	+ 1.1	Apr	+ 1.5	+ 1.1	+ 1.0	+ 1.3	Mar	nil	+ 2.6	Feb	+ 2.5
Italy	+ 2.7	Apr	+ 2.3	+ 2.3	+ 1.9	+ 2.8	Mar	– 0.8	+ 1.7	Mar*	+ 2.1
Japan	– 0.1	Mar	– 1.2	– 0.6	– 0.5	– 0.7	Mar	– 2.5	+ 2.5	Mar	– 0.9
Netherlands	+ 2.7	Mar	+ 3.7	+ 2.6	+ 2.1	+ 3.5	Mar	– 1.7	+ 2.8	Mar	+ 4.4
Spain	+ 3.7	Mar	+ 3.2	+ 3.0	+ 2.6	+ 3.0	Mar	– 0.1	+ 3.9	Q4	+ 3.7
Sweden	+ 3.1	Mar	+ 2.9	+ 2.4	+ 2.0	+ 0.6	Mar	– 0.4	+ 2.1	Feb	+ 3.3
Switzerland	+ 0.7	Apr	+ 1.1	+ 0.7	+ 0.9	+ 0.3	Mar	– 1.3	+ 1.8	2002	+ 2.5
United States	+ 3.0	Mar	+ 1.5	+ 2.3	+ 1.8	+ 4.2	Mar	– 1.6	+ 3.1	Mar	+ 3.3
Euro area	+ 2.1	Apr	+ 2.3	+ 1.8	+ 1.5	+ 2.7	Feb	– 1.1	+ 3.4	Q4	+ 3.2
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*										
Finland	+ 1.6	Mar	+ 1.8	na	na	+ 0.8	Mar	– 0.8	+ 3.3	Q4	+ 4.5
Greece	+ 4.1	Mar	+ 4.0	na	na	+ 2.7	Feb	+ 3.5	na		na
Iceland	+ 2.3	Apr	+ 7.5	na	na	+ 3.3	Apr	+ 8.7	+ 5.7	Mar	+ 8.7
Ireland	+ 4.9	Mar	+ 4.8	na	na	– 5.3	Jan	+ 1.7	+ 6.8	Q4	+ 7.8
Luxembourg	+ 2.7	Mar	+ 2.1	na	na	+ 2.3	Feb	– 2.4	– 1.4	Jan	+ 1.9
New Zealand	+ 2.5	Q1	+ 2.6	na	na	– 0.9	Q4	+ 1.8	+ 2.1	Q4	+ 2.2
Norway	+ 3.7	Mar	+ 1.0	na	na	+ 5.1	Mar	– 4.5	+ 5.2	Q4	+ 4.4
Portugal	+ 3.9	Mar	+ 3.2	na	na	+ 2.1	Mar	– 0.4	+ 0.4	Jan	+ 1.3

*New series.

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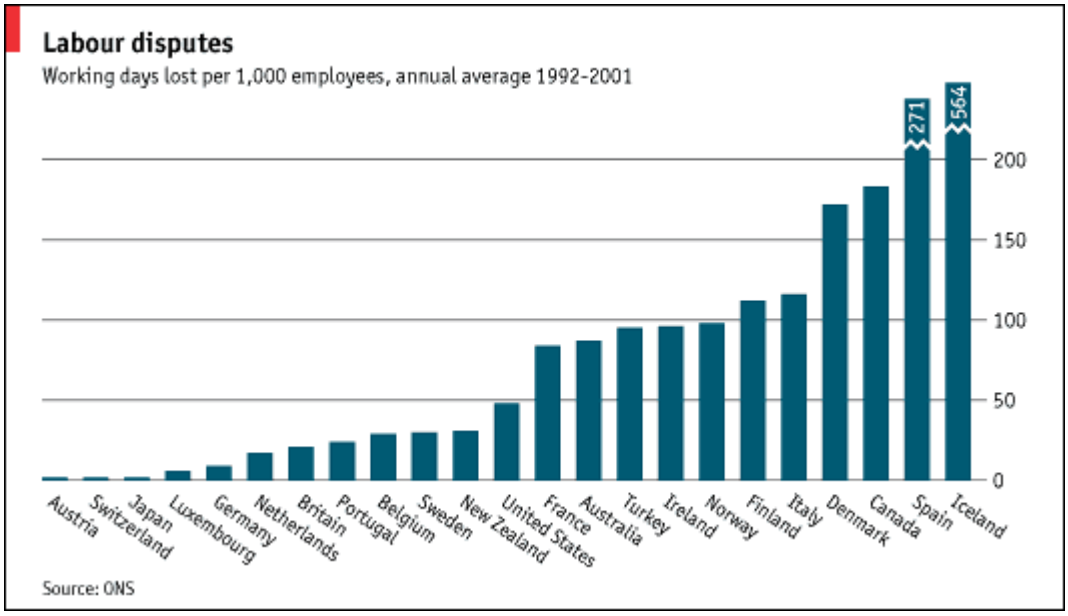
Labour disputes

May 1st 2003
From The Economist print edition



The number of working days lost through labour disputes fell in the 1990s. In 2001, strikes resulted in an average loss of 29 days per 1,000 employees in the OECD group of countries, the lowest since 1983. In the European Union, there was a 45% decline in lost working days between 1992-96 and 1997-2001. Britain, once a byword for strikes, is now less susceptible to them than most other big European countries.

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Money and interest rates

May 1st 2003
From The Economist print edition

	Money supply* % change on year ago			Interest rates % p.a. (Apr 30th 2003)					
				3-mth money market		2-year	10-year gov't bonds		corporate
	narrow	broad		latest	year ago	gov't bonds	latest	year ago	bonds
Australia	–10.0	+10.6	Mar	4.82	4.62	4.55	5.28	6.09	6.12
Britain	+ 6.5	+ 7.3	Mar	3.59	4.06	3.38	4.33	5.14	5.92
Canada	+ 7.0	+ 4.9	Mar	3.22	2.41	3.66	4.98	5.62	6.88
Denmark	+ 8.2	+ 9.2	Mar	2.73	3.73	2.68	4.29	5.29	5.41
Japan	+14.4	+ 1.8	Mar	0.02	0.03	0.04	0.60	1.36	0.72
Sweden	+ 0.4	+ 5.2	Jan	3.43	4.30	3.52	4.59	5.55	4.04
Switzerland	+24.0	+10.0	Mar	0.31	1.50	0.82	2.49	3.39	3.40
United States	+ 3.9	+ 6.2	Mar	1.21	1.77	1.47	3.85	5.06	5.81
Euro area†	+11.6	+ 7.9	Mar	2.53	3.39	2.46	4.06	5.05	4.27

*Narrow: M1 except Britain and Sweden M0, broad: M2 or M3 except Britain M4. †Germany for bonds. Benchmarks: US 30-year 4.77%, Japan No.248 0.61%. Central bank rates: US fed funds 1.25%, ECB refinancing 2.50%, BOJ overnight call 0.002%, BOE repo 3.75%. Sources: Commerzbank, Danske Bank, J.P. Morgan Chase, Royal Bank of Canada, Stockholmsbörsen, UBS Warburg, Global Insight, Westpac, Thomson Datastream. Rates cannot be construed as banks' offers.

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The Economist commodity price index

May 1st 2003
From The Economist print edition

1995=100

	Apr 22nd	Apr 29th*	% change on one month	% change on one year
Dollar index				
All items	76.3	75.8	+ 1.0	+10.3
Food	78.0	78.2	+ 1.9	+14.1
Industrials				
All	74.0	72.6	– 0.4	+ 5.2
Nfa†	79.0	76.5	– 0.9	+12.4
Metals	69.8	69.3	+ 0.1	– 0.6
Sterling index				
All items	76.3	75.2	– 0.1	+ 1.1
Euro index				
All items	91.6	90.5	– 0.1	– 9.8
Yen index				
All items	97.3	96.9	+ 2.5	+ 3.2
Gold				
$ per oz	334.75	334.05	– 0.3	+ 8.6
West Texas Intermediate				
$ per barrel	29.91	25.24	–15.2	– 6.0

* Provisional. † Non-food agriculturals.

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Stockmarkets

May 1st 2003
From The Economist print edition

Market indices

	Apr 30th	2003 high	2003 low	% change on one week	% change on record high	% change on Dec 31st 2002 in local currency	% change on Dec 31st 2002 in $ terms
Australia (All Ordinaries)	2,970.9	3,049.6	2,673.3	+ 0.2	-13.6	- 0.2	+10.9
Austria (ATX)	1,229.2	1,229.2	1,120.2	+ 2.7	-29.2	+ 6.9	+13.6
Belgium (Bel 20)	1,871.8	2,074.1	1,426.6	- 2.4	-49.2	- 7.6	- 1.7
Britain (FTSE 100)	3,926.0	4,009.5	3,287.0	- 1.0	-43.3	- 0.4	- 1.1
Canada (Toronto Composite)	6,586.1	6,837.3	6,228.6	- 0.5	-42.2	- 0.4	+ 9.7
Denmark (KBX)	176.1	176.1	145.0	+ 1.2	-41.6	+ 5.9	+12.6
France (SBF 250)	1,986.9	2,144.8	1,630.1	+ 0.2	-54.7	- 3.2	+ 2.9
(CAC 40)	2,953.7	3,210.3	2,403.0	- 0.3	-57.3	- 3.6	+ 2.5
Germany (DAX)	2,942.0	3,157.3	2,203.0	- 1.1	-63.5	+ 1.7	+ 8.1
Italy (BCI)	1,112.9	1,142.4	959.4	nil	-49.0	+ 1.9	+ 8.3
Japan (Nikkei 225)	7,831.4	8,790.9	7,607.9	+ 0.5	-79.9	- 8.7	- 9.2
(Topix)	796.6	865.4	770.6	+ 0.9	-72.4	- 5.5	- 6.0
Netherlands (AEX)	282.6	337.3	218.4	- 3.1	-59.7	-12.4	- 6.9
Spain (Madrid SE)	675.0	684.6	576.8	- 1.1	-41.1	+ 6.5	+13.2
Sweden (Affarsvarlden Gen)	150.4	153.4	127.8	+ 3.1	-62.4	+ 3.6	+10.4
Switzerland (Swiss Market)	4,542.7	4,965.3	3,675.4	- 1.0	-46.0	- 1.9	- 0.0
United States (DJIA)	8,480.1	8,842.6	7,524.1	- 0.4	-27.7	+ 1.7	+ 1.7
(S&P 500)	916.9	931.7	800.7	- 0.2	-40.0	+ 4.2	+ 4.2
(NASDAQ Comp)	1,464.3	1,471.3	1,271.5	- 0.1	-71.0	+ 9.6	+ 9.6
Europe (FTSE Eurotop 300)*	821.0	890.8	682.7	- 1.4	-51.8	- 4.2	+ 1.8
Euro area (FTSE Ebloc 100)*	699.0	757.2	565.7	- 1.5	-54.9	- 2.7	+ 3.4
World (MSCI)†	813.3	830.7	710.8	+ 0.3	-43.9	na	+ 2.7
World bond market (Citigroup)‡	548.2	551.7	518.6	+ 1.7	- 0.6	na	+ 4.3

*In euro terms. †Morgan Stanley Capital International index includes individual markets listed above plus eight others, in dollar terms. ‡Citigroup World Government Bond Index, total return, in $ terms.

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Trade, exchange rates and budgets

May 1st 2003
From The Economist print edition

	Trade balance*, $bn latest 12 months		Current account $bn latest 12 mths		The Economist poll % of GDP, forecast 2003	2004	Exchange rate trade-weighted† 1990=100 Apr 30th	year ago	Currency units per $ Apr 30th	year ago	per £	per euro	per ¥100	Budget balance % of GDP 2003‡
Australia	− 6.7	Feb	− 17.7	Q4	− 4.7	− 3.9	79.6	75.4	1.60	1.86	2.55	1.78	1.34	0.2
Austria	+ 0.6	Jan	+ 0.9	Jan	− 0.7	− 0.9	101.7§	100.3	0.90	1.10	1.43	–	0.75	-1.3
Belgium	+ 17.4	Feb	+ 11.8	Dec	+ 4.9	+ 4.9	101.4§	99.0	0.90	1.10	1.43	–	0.75	nil
Britain	− 55.5	Feb	− 13.1	Q4	− 1.8	− 1.6	99.2	106.6	0.63	0.68	–	0.70	0.52	-1.9
Canada	+ 35.0	Feb	+ 11.0	Q4	+ 1.6	+ 1.7	81.8	77.1	1.43	1.56	2.29	1.60	1.20	1.1
Denmark	+ 8.6	Feb	+ 5.6	Feb	+ 2.0	+ 1.9	105.9	102.2	6.66	8.20	10.6	7.42	5.58	1.6
France	+ 8.9	Feb	+ 28.3	Feb	+ 1.7	+ 1.6	104.5§	101.6	0.90	1.10	1.43	–	0.75	-3.6
Germany	+122.8	Feb	+ 46.9	Feb	+ 1.9	+ 1.8	101.8§	98.5	0.90	1.10	1.43	–	0.75	-3.7
Italy	+ 7.5	Feb	− 9.6	Feb	− 0.4	− 0.3	74.5§	72.5	0.90	1.10	1.43	–	0.75	-2.4
Japan	+ 95.9	Feb	+115.0	Feb	+ 2.6	+ 2.9	129.0	131.2	119	127	191	133	–	-7.7
Netherlands	+ 29.5	Feb	+ 9.1	Q4	+ 3.2	+ 3.2	100.7§	97.9	0.90	1.10	1.43	–	0.75	-1.6
Spain	− 40.8	Jan	− 17.4	Jan	− 2.2	− 2.1	76.0§	74.2	0.90	1.10	1.43	–	0.75	-0.4
Sweden	+ 15.2	Mar	+ 9.9	Dec	+ 3.6	+ 3.5	80.5	75.4	8.18	10.2	13.1	9.12	6.86	0.7
Switzerland	+ 4.8	Mar	+ 32.0	Q4	+11.2	+11.4	113.9	113.9	1.36	1.61	2.17	1.51	1.14	na
United States	−503.7	Feb	−503.4	Q4	− 5.4	− 5.3	105.8	119.6	–	–	1.60	1.12	0.84	-4.6
Euro area	+ 95.6	Feb	+ 53.1	Feb	+ 0.8	+ 0.8	89.0	79.1	0.90	1.10	1.43	–	0.75	-2.5
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*													
Finland	+ 13.5	Feb	+ 10.1	Feb	na	na	80.4§	78.2	0.93	1.10	1.48	–	0.78	3.1
Greece	− 22.3	Feb	− 10.8	Feb	na	na	58.7§	57.5	0.93	1.10	1.48	–	0.78	-1.0
Iceland	+ 0.2	Feb	nil	Q4	na	na	93.0**	80.4	77.1	93.1	123	86.0	64.6	nil
Ireland	+ 36.1	Jan	− 0.2	Q4	na	na	91.6§	87.2	0.93	1.10	1.48	–	0.78	-0.8
Luxembourg	− 3.0	Jan	+ 1.7	Q4	na	na	101.4§	99.0	0.93	1.10	1.48	–	0.78	0.2
New Zealand	− 0.9	Mar	− 1.9	Q4	na	na	96.6	86.5	1.82	2.23	2.90	2.03	1.52	0.8
Norway	+ 28.1	Mar	+ 28.1	Feb	na	na	102.4	101.4	7.27	8.35	11.6	8.11	6.09	11.3
Portugal	− 12.6	Jan	− 9.2	Jan	na	na	91.3**	89.9	0.93	1.10	1.48	–	0.78	-3.2

*Merchandise. Australia, Britain, France, Canada, Japan and United States imports fob, exports fob. All others cif/fob. †Bank of England except §IMF, January average. ‡OECD forecast. **IMF, November average.

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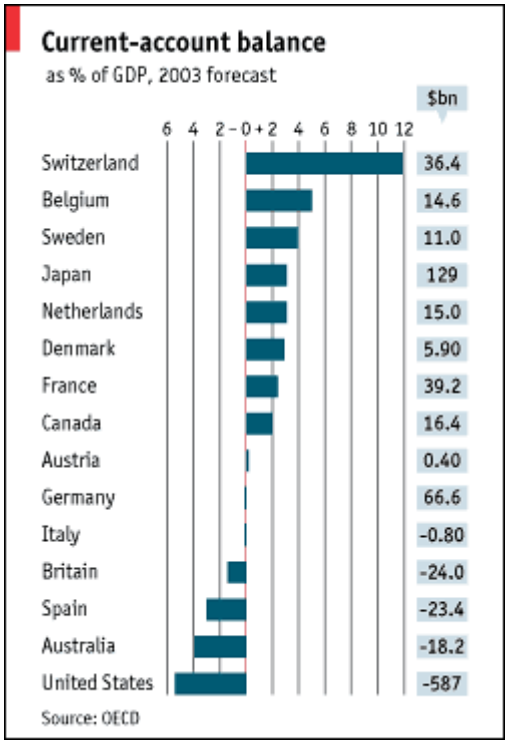
Current-account balance

May 1st 2003
From The Economist print edition



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Overview

May 1st 2003
From The Economist print edition

Brazil's current account moved into surplus in March, helping to narrow the 12-month deficit to less than 1% of GDP. This was the first surplus for this quarter in a decade.

South Korea's current-account deficit widened to $1.2 billion in March, its largest shortfall since before the economy had to be bailed out by the IMF six years ago. The rate of growth in the country's industrial production slowed to 4.5% in the year to March, from 10.2% in February.

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The Economist poll of forecasters

May 1st 2003
From The Economist print edition

Every three months, *The Economist* polls a group of forecasters and averages their predictions for economic growth and current-account balances in 25 emerging economies. Overall, our panel has become gloomier over the past three months. Average forecasts for GDP growth in 2003 have been reduced in 16 emerging economies. In January, our seers expected Venezuela's economy to shrink by 2.1% in 2003. Now they expect a 14.1% contraction. Growth forecasts for Hong Kong and Singapore have been cut in half, to 1.6% and 1.8%, respectively. China's economy, however, is still expected to grow by 7.5% in 2003. Depending upon the progress of SARS, that forecast may also prove too rosy.

April

	Real GDP % change		Current account % of GDP	
	2003	2004	2003	2004
China	7.5	7.4	0.9	0.7
Hong Kong	1.6	3.7	10.7	11.3
India	5.8	6.1	0.5	0.6
Indonesia	3.5	4.1	3.5	3.1
Malaysia	4.0	5.0	6.8	6.1
Philippines	3.7	4.1	4.0	3.7
Singapore	1.8	4.7	21.2	19.9
South Korea	4.2	5.4	0.3	0.3
Taiwan	3.2	3.9	6.5	6.2
Thailand	4.4	4.9	4.4	4.0
Argentina	2.8	3.8	7.5	6.0
Brazil	1.9	3.0	−1.0	−1.1
Chile	3.4	4.4	−1.0	−1.2
Colombia	2.0	3.0	−2.1	−2.3
Mexico	2.5	4.0	−2.6	−2.8
Peru	4.0	4.2	−1.9	−2.0
Venezuela	−14.1	5.5	8.0	7.5
Egypt	2.3	3.9	−1.8	−1.1
Israel	0.8	3.2	−1.7	−1.6
South Africa	2.8	3.4	−0.5	−0.8
Turkey	2.6	4.0	−1.9	−1.6
Czech Republic	2.7	3.5	−4.7	−4.1
Hungary	3.5	4.0	−4.7	−4.1
Poland	2.7	3.8	−3.6	−3.8
Russia	4.6	4.3	7.4	4.2

Sources: ABN Amro; Deutsche Bank; Economist Intelligence Unit; Goldman Sachs; HSBC; ING Financial Markets; J.P.Morgan Chase; Merrill Lynch; Salomon Smith Barney; UBS Warburg.

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Economy

May 1st 2003
From The Economist print edition

	% change on year ago						Latest 12 months, $bn				Foreign reserves* $bn, latest	
	GDP		Industrial production		Consumer prices		Trade balance		Current account			
China	+ 9.9	Q1	+16.9	Mar	+ 0.9	Mar	+22.1	Mar	+33.5	2002†	309.2	Jan
Hong Kong	+ 5.0	Q4	– 9.2	Q4	– 2.1	Mar	– 8.0	Mar	+13.8	Q4	113.6	Mar
India	+ 2.6	Q4	+ 6.4	Feb	+ 4.1	Mar	– 9.0	Mar	+ 4.8	Q4	71.1	Mar
Indonesia	+ 3.8	Q4	+ 6.7	Jan	+ 7.5	Apr	+25.6	Mar	+ 7.5	Q3	31.1	Feb
Malaysia	+ 5.6	Q4	– 0.9	Feb	+ 0.7	Mar	+14.3	Feb	+ 7.3	Q4	33.8	Mar
Philippines	+ 5.8	Q4	+ 4.9	Jan	+ 2.9	Mar	+ 0.2	Feb	+ 6.1	Sep	12.9	Mar
Singapore	+ 1.5	Q1	+ 6.5	Mar	+ 0.8	Mar	+11.1	Mar	+18.7	Q4	83.5	Mar
South Korea	+ 6.8	Q4	+ 4.5	Mar	+ 3.7	Apr	+ 8.0	Apr	+ 2.9	Mar	123.8	Mar
Taiwan	+ 4.2	Q4	+ 1.6	Mar	– 0.2	Mar	+16.6	Mar	+25.8	Q4	168.6	Mar
Thailand	+ 6.1	Q4	+12.7	Mar	+ 1.6	Apr	+ 3.9	Mar	+ 8.5	Mar	37.9	Feb
Argentina	– 3.6	Q4	+15.4	Mar	+31.7	Mar	+15.9	Mar	+ 8.9	Q4	10.3	Feb
Brazil	+ 3.4	Q4	+ 4.1	Feb	+16.7	Mar	+16.0	Mar	– 4.4	Mar	38.4	Feb
Chile	+ 3.2	Q4	+ 6.9	Mar	+ 4.5	Mar	+ 2.5	Mar	– 0.6	Q4	16.5	Feb
Colombia	+ 2.0	Q4	+ 5.7	Jan	+ 7.6	Mar	nil	Dec	– 1.6	Q4	10.5	Mar
Mexico	+ 1.9	Q4	+ 1.2	Feb	+ 5.6	Mar	– 6.7	Mar	–14.5	Q4	52.0	Feb
Peru	+ 5.3	Feb	+ 4.2	Feb	+ 3.4	Mar	+ 0.4	Feb	– 1.1	Q4	9.8	Mar
Venezuela	–16.7	Q4	–64.8	Dec	+34.1	Mar	+13.9	Q4	+ 7.6	Q4	8.6	Dec
Egypt	+ 3.1	2002†	+ 4.2	2002†	+ 3.1	Feb	– 7.4	Jan	+ 0.5	Q4	13.2	Dec
Israel	+ 1.3	Q4	+ 3.0	Jan	+ 4.8	Mar	– 5.7	Mar	– 2.1	Q4	23.7	Mar
South Africa	+ 3.0	Q4	+ 0.4	Feb	+12.5	Mar	+ 3.6	Mar	+ 0.3	Q4	6.1	Feb
Turkey	+11.4	Q4	+ 4.4	Feb	+29.4	Mar	–16.4	Feb	– 2.7	Feb	27.9	Feb
Czech Republic	+ 1.5	Q4	+ 5.2	Feb	– 0.4	Mar	– 2.6	Mar	– 3.5	Q4	24.7	Mar
Hungary	+ 3.7	Q4	+ 1.6	Feb	+ 4.7	Mar	– 3.6	Feb	– 3.0	Feb	13.6	Mar
Poland	+ 2.1	Q4	+ 5.7	Mar	+ 0.6	Mar	–10.1	Mar	– 5.9	Mar	30.0	Mar
Russia	+ 4.3	Q3	+ 6.7	Mar	+14.8	Mar	+50.2	Feb	+38.3	Q1	51.8	Mar
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*											
Pakistan	+ 3.6	2002†	+15.8	Nov	+ 2.3	Mar	– 1.5	Mar	+ 2.7	2002†	10.3	Mar
Saudi Arabia	+ 1.2	2001	na		– 0.9	Jan	+39.2	2001	+ 9.4	2001	21.2	Jan

*Excluding gold, except Singapore; IMF definition. †EIU est. †Year ending June. ‡New series.

Sources: National statistics offices, central banks and stock exchanges; Thomson Datastream; Economist Intelligence Unit; Reuters; J.P. Morgan Chase; Hong Kong Monetary Authority; Centre for Monitoring Indian Economy; FIEL; EFG-Hermes; Bank Leumi Le-Israel; Standard Bank Group; Akbank; Deutsche Bank

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Financial markets

May 1st 2003
From The Economist print edition

	Currency units			Interest rates	Stockmarkets	% change on		
	per $		per £	short-term	Apr 30th		Dec 31st 2002	
	Apr 30th	year ago	Apr 30th	% p.a.		one week	in local currency	in $ terms
China	8.28	8.28	13.2	na	1,592.2	– 1.3	+ 12.2	+ 12.2
Hong Kong	7.80	7.80	12.5	1.56	8,717.2	+ 2.3	– 6.5	– 6.5
India	47.3	48.9	75.6	4.94	2,959.8	+ 0.4	– 12.4	– 11.2
Indonesia	8,674	9,328	13,859	11.72	450.9	+ 0.7	+ 6.1	+ 9.5
Malaysia	3.80	3.80	6.07	3.10	630.4	+ 0.1	– 2.5	– 2.5
Philippines	52.5	50.6	83.8	9.88	1,068.2	– 1.5	+ 4.9	+ 6.7
Singapore	1.78	1.81	2.84	0.69	1,281.3	+ 1.2	– 4.5	– 6.7
South Korea	1,215	1,289	1,941	4.54	599.4	+ 0.2	– 4.5	– 6.8
Taiwan	34.8	34.7	55.6	1.35	4,148.1	– 9.1	– 6.8	– 6.9
Thailand	42.9	43.3	68.5	1.76	374.6	– 0.2	+ 5.1	+ 5.7
Argentina	2.83	2.96	4.51	7.10	636.0	– 5.1	+ 21.1	+ 44.3
Brazil	2.89	2.36	4.61	26.32	12,556.7	+ 1.3	+ 11.4	+ 36.7
Chile	705	647	1,126	2.52	5,679.6	+ 4.8	+ 13.1	+ 15.7
Colombia	2,867	2,279	4,581	7.72	1,722.7	+ 1.1	+ 7.1	+ 7.1
Mexico	10.29	9.44	16.4	6.73	6,509.9	+ 2.0	+ 6.2	+ 8.0
Peru	3.46	3.43	5.53	3.81	1,768.6	+ 0.3	+ 27.1	+ 29.0
Venezuela	1,598	856	2,553	25.52	8,631.6	+ 2.5	+ 7.7	– 6.5
Egypt	5.94	4.64	9.48	12.29	7,122.9	+ 4.2	+ 32.6	+ 3.4
Israel	4.55	4.88	7.27	5.82	392.7§	+ 1.6	+ 18.1	+ 23.3
South Africa	7.3	10.6	11.6	13.75	7,510.4	– 3.1	– 19.0	– 4.5
Turkey	1,566,000	1,363,500	2,502,311	39.00	11,510.0	+ 0.9	+ 11.0	+ 17.7
Czech Republic	28.2	33.9	45.0	2.48	520.7	+ 0.8	+ 13.0	+ 20.7
Hungary	220	268	352	6.50	8,166.3	+ 3.9	+ 4.7	+ 6.8
Poland	3.81	3.99	6.08	5.69	14,259.8	– 0.6	– 0.7	– 0.1
Russia	31.1	31.2	49.7	18.00	422.4‡	– 1.6	+ 14.5	+ 17.6
EMF (MSCI)*	1.00	1.00	1.60	na	295.2	+ 0.4	na	+ 1.1
EMBI+†	1.00	1.00	1.60	na	261.6	+ 1.9	na	+ 14.3

*Emerging Mkts Free. †J.P. Morgan Chase's Emerging Mkts Bond Index Plus. ‡ In $ terms. §Apr 29th.

Sources: National statistics offices, central banks and stock exchanges; Thomson Datastream; Economist Intelligence Unit; Reuters; J.P. Morgan Chase; Hong Kong Monetary Authority; Centre for Monitoring Indian Economy; FIEL; EFG-Hermes; Bank Leumi Le-Israel; Standard Bank Group; Akbank; Deutsche Bank

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